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CHARLES ELMORE CROPLEY

No. 81

In the Supreme Court of the United States

OCTOBER TERM, 1944

OTIS & CO., PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION AND THE UNITED LIGHT AND POWER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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OPINIONS BELOW

The findings and opinion of the Securities and Exchange Commission (R. 2, 77), not yet officially reported, are set forth in the Commission's Holding Company Act Release No. 4215. The opinion of the United States District Court for the District of Delaware (R. 82) is reported in 51 F. Supp. 217. The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 123) is reported in 142 F. (2d) 411.

JURISDICTION

The judgment of the United States Circuit Court of Appeals for the Third Circuit was entered April 20, 1944 (R. 142). The petition for a writ of certiorari was filed on May 11, 1944, and granted June 12, 1944 (R. 144). The jurisdiction of this Court is invoked under Section 240 of the Judicial Code as amended by the Act of February 13, 1925, the provisions of which are made applicable by Section 25 of the Public Utility Holding Company Act of 1935 (the "Act"; 49 Stat. 803, 15 U. S. C. § 79a et seq.).

STATUTE INVOLVED

The applicable provisions of the Act are set forth in Appendix A, *infra*, pp. 80–91. The substance of the relevant statutory provisions is as follows:

Under Section 11 (b) (2) of the Act, it is the duty of the Commission to require all registered holding companies and their subsidiaries to "take such steps as the Commission shall find necessary" to simplify the structures of their holding company systems and to correct the distribution of voting power. Included in the section is a specific instance of undue complications the correction of which is mandatory; namely, that which occurs where there exist in a holding company system more than two tiers of holding companies. This requirement of Section 11 (b) (2), applicable in this case, is sometimes referred to

as the "great-grandfather" provision. Orders under Section 11 (b) are reviewable in a circuit court of appeals and are to be complied with within one year from the date of the order unless the time for compliance is extended for cause.

To enable the Commission to *compel* compliance with its orders issued under Section 11 (b), the Commission is authorized by Section 11 (d) of the Act to resort to the district courts of the United States for enforcement thereof; and the courts are empowered, *inter alia,* to dispose of the corporate assets "in accordance with a fair and equitable reorganization plan which shall have been approved by the Commission after opportunity for hearing."

Of immediate application here is Section 11 (e) relating to *voluntary* compliance. Section 11 (e) permits a company subject to Section 11 (b) to "submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling" the company to comply with Section 11 (b). The Commission, after notice and opportunity for hearing, is authorized to consider whether the plan is "necessary to effectuate the provisions of subsection (b) *and fair and equitable to the persons affected by such plan,*" and if the Commission so finds, to make an order approving the plan. Thereafter, the Commission

is empowered, at the request of the company, to apply to a district court "to enforce and carry out the terms and provisions of such plan." The court, after notice and opportunity for hearing, is authorized to "approve such plan as *fair and equitable* and as appropriate to effectuate the provisions of section 11"[1] and is vested with jurisdiction to enforce the plan so approved.

PRELIMINARY STATEMENT OF QUESTIONS PRESENTED

The ultimate issue in this case is whether the Commission and the district court were warranted in approving as "fair and equitable," within the meaning of Section 11 (e) of the Act, a plan of compliance with Section 11 (b) submitted by The United Light and Power Company (hereinafter referred to as Power). The plan affects only the interests of Power's preferred and common stockholders, after full provision for creditors' claims, and accords both classes of stockholders continuing interests in the same underlying enterprise in the form of common stock of a subsidiary holding company one step "nearer to the rails." The new stock was allocated among Power's preferred and common stockholders respectively in the proportion of approximately 95–5%, which was in accordance with the Commission's appraisal of their respective interests in the enterprise as they exist apart from the requirements of Section 11.

[1] No question was raised in the present case as to the findings that the plan was necessary and was appropriate to effectuate the provisions of Section 11.

This appraisal took into account the entire bundle of rights affected. While the Commission observed that the present value of Power's assets is less than the charter liquidation preference of the preferred, the charter gives preferred stockholders no right to mature their liquidation preference, and, accordingly, the common stockholders are entitled (apart from the Act) to continue in the enterprise with what the Commission found to be a reasonable prospect of participating in future earnings after the eventual discharge of preferred dividend arrears. The Commission interpreted Section 11 (e) as not intended to give a windfall to any class of investors at the expense of another, and therefore as requiring it to treat the liquidation preference of the preferred stock as unmatured for the purpose of determining what allocation of Railways' stock would represent the "equitable equivalent of the rights surrendered" by each class of stock affected. On this theory it concluded that an allocation of 95% of Railways' stock to Power's preferred stockholders constituted full recognition of their "absolute priority." This is in accordance with standards of fairness which the Commission had consistently applied under Section 11 (e) to corporate readjustments where elimination of the corporate entity was not involved. The only new circumstance involved in the present case is that instead of recapitalizing the holding company or merging it with a subsidiary, as was done in prior cases,

the readjustment here substitutes a subsidiary for the parent company by distributing the common stock of the subsidiary to the stockholders of the parent in "liquidation" of the latter.

Commissioner Healy has consistently dissented from the views of a majority of the Commission in the various decisions which have applied this test. Petitioner, relying on these dissents, argues that either the readjustment process itself, or the statutory necessity for reorganization, must be treated as maturing the liquidation preference of the preferred stock and that, therefore, the liquidation preference of the preferred stock becomes the sole measure of its right to participate in a plan under Section 11 (e). In other words, petitioner insists that the legitimate investment value represented by the common stockholders' interest in future earnings must be sacrificed to the preferred stock as a direct result of the operation of Section 11. Additional strength for this contention is sought to be derived here from the circumstance that in this particular case a prior order of the Commission required the liquidation of Power as a separate corporate entity in the holding company system and, in conformity with that order, the plan in question takes the form of a plan of liquidation.

Two questions are therefore presented:

(1) Is the Commission required to treat the liquidation preference as the sole and controlling

measure of preferred stockholders' rights in any type of readjustment of stockholders' rights submitted under Section 11 (e) of the Act?

(2) Assuming that the standard applied by the Commission in this case is one which would have been properly applicable in the event of a recapitalization or merger, does the circumstance that the readjustment takes the form of a "liquidation" of Power require a different standard in which charter liquidation preferences are the sole measure of the stockholders' rights?

STATEMENT

(A) PROCEEDINGS BEFORE THE COMMISSION

Power is a registered holding company organized in 1923 under the laws of Maryland. At December 6, 1940, the date of the commencement of the Commission's proceedings with respect to Power, there were fifty-two companies, including seven registered holding companies, in the Power holding company system. Power, at the top, owned directly the securities of a number of its utility operating subsidiaries, but most of the operating companies were controlled indirectly through The United Light and Railways Company (hereinafter referred to as Railways), a principal subholding company, which in turn controlled its operating subsidiaries through additional intermediate holding companies.

Earlier in the proceeding, on March 20, 1941, the Commission ordered Power to liquidate and dissolve in order to comply with the requirements of Section 11 (b) (2) and particularly the second sentence thereof, commonly known as the "great-grandfather" provision (R. 120). No review was sought of that order.

Thereafter, the Commission approved various applications filed by Power for approval of steps

necessary to carry out the required liquidation. These included provision for all of Power's funded debt. As the final step in its program of liquidation, Power submitted to the Commission in Application No. 14 a plan for the retirement of its remaining debt (consisting of $1,500,000 of bank notes), for the transfer of miscellaneous assets as a capital contribution to Railways and for the distribution of Power's remaining asset, the common stock of Railways, to the holders of its preferred and common stocks on the basis of an allocation of 91.2% of such common stock to Power's preferred stockholders and 8.8% to its common stockholders.[2]

Evidence was taken on this plan, and thereafter the Commission issued its opinion disapproving the company's proposed allocation as being too generous to the common stock but finding that an allocation of approximately 5% to the common stock would be fair (R. 2). In accordance with that opinion, the plan was modified to provide for the allocation of 94.52% and 5.48% of Railways' common stock to Power's preferred and common stockholders, respec-

[2] Power's Class A and Class B common stock have identical rights except that voting rights are vested exclusively in the Class B common. To simplify analysis we refer to the combined interests of both classes under the generic term, "common stock," as did the Commission and the courts below.

tively [5] (R. 98). With this modification the plan was approved by the Commission as fair and equitable (R. 77, 78). Subsequent references herein to the plan mean the plan as so modified.

(B) PROCEEDINGS BELOW

Pursuant to Section 11 (e) of the Act, the Commission, at the request of Power, applied to the United States District Court for the District of Delaware to enforce the plan (R. 82). The district court, after notice and hearing (R. 121), approved the plan by judgment entered August 4, 1943 (R. 95). On appeal by Otis & Co., a preferred stockholder which had appeared in opposition to the fairness of the plan in the district court, the circuit court of appeals unanimously affirmed the judgment of the district court (R. 123, 142).[6]

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[5] The specific percentages reflect an allotment of five shares of Railways' common for each share of Power's preferred and one share of Railways' common for each 20 shares of Power's common. There was, of course, no pretense of decimal accuracy in the allocation.

[6] Power's brief in this Court (p. 6) emphasizes petitioner's failure to seek direct review in a circuit court of appeals (under Section 24 (a) of the Act) of the Commission's order approving the plan. The Commission, however, has taken the position that an order approving a plan to be consummated only after hearing and approval of the plan by a district court is not a reviewable order within the scope of Section 24 (a). See *Okin* v. *S. E. C.* (C. C. A. 2d), decided October 24, 1944.

(C) THE FACTUAL BASIS OF THE COMMISSION'S CONCLUSION THAT THE PLAN IS "FAIR AND EQUITABLE"

We do not conceive that there remains any issue before this Court as to the facts found by the majority of the Commission, inasmuch as the petitioner, in appealing from the district court's order, did not bring up the factual record to the circuit court of appeals; nor is it here. Moreover, petitioner does not challenge the amount of the allocation to common stockholders once it be determined that they are entitled to any participation under the plan. We nevertheless set forth below an analysis of the majority's interpretation of the facts for the light it throws upon the practical operation of the standard of fairness applied in this case.

The basic problem before the Commission was what distribution of the common stock of Railways between Power's two classes of stockholders would be fair and equitable. One factor considered by the Commission was that the preferred had a preferential right by charter to receive $100 per share plus $64.50 accumulated dividends (as of December 31, 1942) on "voluntary or involuntary" dissolution or liquidation, or an aggregate of $98,700,000, including dividend arrearages, on the outstanding 600,000 shares, before any payment might be made to the common (R. 9). All members of the Commission con-

cluded that the value of Railways' common stock was less than the liquidation preference of Power's preferred stock, and that if the sole basis of allocation was the charter liquidation preference, then the common stockholders could take nothing (R. 9–11, 44).

The factual analysis used by the majority of the Commission went beyond this point, however. The majority considered the past earnings of Power and Railways, on both corporate and consolidated bases with adjustments for certain nonrecurring items, in order to arrive at an estimate of the future earning power of Railways' common stock. Power's corporate income since 1932 had been less than the annual preferred dividend requirement of $3,600,000, but the consolidated net income had fluctuated widely, and over the period of 1929–41 had produced a net balance in excess of the current requirements of Power's preferred stock of over $18,000,000 (R. 19). The bulk of the consolidated earnings had not, however, been taken up into Railways or Power, and no dividends had been paid on Power's preferred or common stocks since 1932. The $38,700,000 of accumulated arrears of preferred dividends were a non-interest-bearing charge while the $45,000,000 (approximately) of system earnings retained in the business during the 1929–1941 period (R. 19) had been used to strengthen the subsidiary companies of the system. Reflecting in

part better business conditions and in part improvement in earning capacity as a result of this retention of earnings, consolidated earnings applicable to the common stock of Railways for the period 1937–42 (adjusted for certain nonrecurring expenditures) had approximated $6,185,000 as an annual average. Consolidated income for the latest year of this period, 1942 (nine months actual, three months estimated), amounted to approximately $7,100,000. (R. 18–26.)

From the foregoing and the management's testimony as to estimated future earnings, the majority of the Commission concluded that the figure of approximately $6,185,000 representing the 1937–42 average of consolidated earnings might be used as an estimate of future earnings attributable to Railways' common stock, for the purpose of determining the existing rights of Power's preferred and common stocks in the enterprise (R. 24). This figure was considered, however, to be a "very liberal assumption" and was to be discounted accordingly (R. 24–25).[5] On this basis, and assuming that all consolidated net earnings might be applied to the payment of current and accumulated preferred dividends (again, an assumption which the Commission discounted as over-liberal),[6] it would take approximately 15

[5] As explained below (note 8), implicit in the Commission's decision is the application to this estimate of a very high discount rate in view of the high risk factor applicable to such a liberal estimate.

[6] See note 7, *infra*.

years to pay off Power's preferred dividend arrearages (R. 24).

The majority of the Commission emphasized the remote character of the common stockholders' interest and for that reason disapproved the company's proposal to allocate approximately 9% of the common stock of Railways to the common stockholders of Power (R. 24–25). Nevertheless, it was concluded that, absent liquidation or reorganization to comply with Section 11, there was a reasonable possibility that, on the basis of its existing capital structure, Power would ultimately pay off the preferred dividend arrearages and place the common stock on a dividend-paying footing. The possibility was deemed sufficiently substantial to justify an allocation to the common stock, although less than the amount which had been proposed. With respect to the size of the allocation, the majority held that a participation of approximately 5%, "while representing the maximum, would not exceed the permissible limits of fairness" (R. 25–26).

The Commission regarded this determination as "of necessity one of over-all judgment and not susceptible of mathematical demonstration" (R. 25). Without desiring to create an illusion of greater certainty than is possible in dealing with the unknown future, we believe that certain mathematical computations may help to illustrate the relationship between the earnings figures used

by the Commission and its over-all judgment that an allocation in the ratio of approximately 95% to Power's preferred stock and 5% to the common stock would be fair.

If we project the earnings figures found by the Commission forward some 15 years, the preferred dividend arrearages would be paid, whereupon the preferred stock under their existing contract rights would be limited to an annual dividend of $3,600,000, and 100% of all the additional earnings would be applicable to the common. Under the Commission's suggestion of a 5% participation for the common stock of Power, and using the $6,185,000 figure for estimated earnings, the common stockholders would surrender their future 100% interest in $2,585,000 of excess annual earnings to begin in 15 years, in exchange for a 5% interest in the entire $6,185,000 estimated annual earnings, or $309,250, beginning at once and continuing indefinitely.[7] In turn, the pre-

[7] This analysis concededly involves some over-simplification. We are speaking of estimated consolidated earnings which would not as a practical matter be entirely distributed in dividends. To the extent that such earnings would be retained in the business, the amount immediately payable would necessarily be reduced, thereby delaying progress in discharging the dividend arrears. On the other hand, retention of earnings without the necessity of paying interest on the unpaid preferred dividends might result in increasing the aggregate earnings distributable over the 15-year period. How much these factors would ultimately affect the amount available for the common stock after the dividend arrears should be paid, and the time required to pay off arrears,

ferred stockholders would surrender approximately 5% of their exclusive interest in all earnings during the 15-year period and in the first $3,600,000 of income thereafter. In addition to retaining the remaining 95% of their present interest in these earnings, the preferred stockholders receive a new right in perpetuity to 95% of any earnings in excess of their existing preferential claim, which excess on the basis of the above figures would begin to be available at the expiration of 15 years and amount to $2,456,000 per annum. Expressed in terms of a per share basis preferred stockholders give up a present interest in earnings at the rate of approximately $10.31 per share for 15 years and $6 per share thereafter, in return for earnings of $9.79 applicable to the new shares in perpetuity. Implicit in the conclusion that these new respective interests in earnings, allocated to preferred and common stockholders, are the fair equivalents of what they are giving up, is an application of a discount rate of approximately 15% to the $6,185,000 estimate of future earnings.[8]

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would depend upon the amount of additional income received from the earnings retained in the business.

[8] The difference between what the common stockholders would surrender after elimination of arrears and what they would receive under the Commission's suggested allocation (a ratio of about 8.4 to 1) indicates how the Commission appraised the advantage to the common stock of the elimination of the 15-year delay, the $3,600,000 annual preference of the preferred stock, and the risk that distributable earnings

In the following charts, the participation of the common stock in Railways' earnings prospects is represented by the shaded portion; chart I represents the present situation, and chart II represents the effect of the plan.

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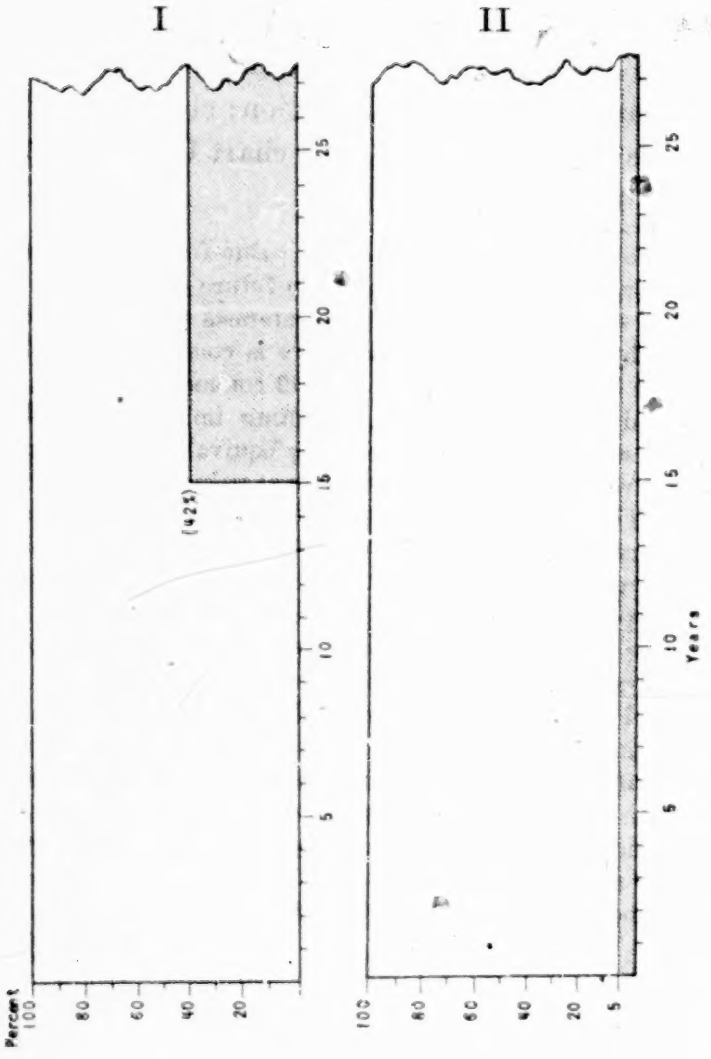
might prove less than the estimate. But for the inherent risk factor, the difference between the future interests which would be surrendered and the new interests presently to be received by the common stockholders is comparable to the difference between an annuity of $8.40 commencing 15 years hence and an annuity of $1 beginning immediately. To make these annuities mathematically equivalent, the larger would have to be discounted to present value at the rate of 15.2%. This very high discount rate measures the risk factor involved in the assumption by the majority of the Commission that Power's common stock had a reasonable prospect of receiving an estimated $2,585,000 annually beginning 15 years in the future, and offsets the "very liberal" character of the estimate of consolidated earnings.

Under Power's original plan of allotting 8.8% to the common stock, the common would have been given a present annuity of $544,280 in lieu of the future annuity of $2,585,000. This would have indicated a discount rate of 11%, a ratio which justifies the conclusion implicit in the Commission's rejection of Power's original plan that the common was being allotted too much in view of the risks involved.



In justifying its assumption that it had adequately discounted the risks involved in its estimate of earnings, the Commission pointed out that the earnings of a top holding company in a pyramided system are subject to wide fluctua-

tions.[9] An unexpected increase of only a few percent in operating company earnings will be magnified into a very great improvement at the holding company level. Accordingly, the Commission found it appropriate to consider the possibility that future earnings might actually exceed even its "very liberal" estimates, as well as the risk that they might be substantially less.

Summarizing these considerations, the Commission stated (R. 25–26):

> This conclusion takes into consideration the fact that, to the extent its earnings should perchance exceed those estimated, the common stock, in exchange for an allocation of approximately 5% would be giving up its claim to 95% of any possible excess over the amount necessary to sat-

[9] The leverage position of Power's security holders is illustrated by the following table in the record before the Commission and before the district court showing fluctuations in consolidated earnings available for the senior securities of Power for the years ended December 31, 1931–1939:

Year ended December 31—	Percent of change over preceding year		
	Subsidiary income before fixed charges	Income available for Power's fixed charges	Net income applicable to Power's preferred stock
1931	−8	−19	−25
1932	−14	−35	−47
1933	−15	−43	−64
1934	−5	−13	−35
1935	+7	+40	+144
1936	+8	+41	+87
1937	+3	+9	+15
1938	−10	−28	−40
1939	+6	+27	+49

isfy the dividend preferences of the preferred. In other words, as the participation of the common stock approaches zero it is giving up, in exchange therefor and for the benefit of the preferred stock, nearly 100% of its chance of participating in any future earnings in excess of the existing preferences of the preferred. On the other hand, if earnings do not equal such preferences, the preferred stock gives up but approximately 5% of the earnings actually realized.*

Under the circumstances here present, we are unwilling to permit the complete elimination of the common stock. Our conclusion in this regard is reinforced by reason of our belief that the whole future program of corporate simplification and geographic integration of the system, as in the case of the present step in such program, will result in an improvement of the investment position of both the preferred and common stock. That improvement, we believe, should be shared by the common as well as by the preferred, and the process of securing such improvement in compli-

* In considering the possible margin of error inherent in any attempt to forecast future earnings, allowance must be made for the fact that we are dealing with a top company in a pyramided structure. As a result of "leverage" any fluctuations in underlying earnings are greatly magnified in their impact upon earnings available for securities of the top holding company.

ance with the Act should not be permitted to destroy existing investment values.

Accordingly, the majority held that the allocation of 5% to Power's common stock was a fair allocation taking account of all the considerations involved. Commissioner Healy's dissenting opinion (R. 37), which, as the court below noted (R. 126; and see Pet. Br., p. 28), has been in substance adopted by the petitioner as its argument, sharply disagreed with this conclusion.

The dissent rests primarily upon the disagreement with the majority's interpretation of the "fair and equitable" standard of Section 11 (e), which is the basis for the petitioner's argument here. In addition, there was a substantial difference in the dissenting Commissioner's interpretation of the facts. While this factual difference may involve some difference in judgment as to prospective future income attributable to the common stock of Railways, it would seem that even this apparent factual difference is primarily a reflection of a different conception of the applicable standard of law.[10] In any event, as has been stated, we do not regard these factual differences as now in issue.

[10] As stated above, the majority opinion expressly describes the estimates used by it as "liberal." The dissent merely emphasizes the basis for assuming that future earnings may actually be less than the majority assumes. However, the majority's use of a concededly liberal estimate is compensated for by the high discount rate which we have indicated is implicit in the conclusion that common stockholders' par-

SUMMARY OF THE ARGUMENT

Section 11 was intended to bring about the geographic integration and simplification of holding company systems without destruction of any legitimate investment interest in the existing structures, and the "fair and equitable" standard

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ticipation should be limited to approximately 5%. See note 8, *supra*. This applies both to Commmissioner Healy's criticism that the adjustment of past earnings for nonrecurrent items is based upon too liberal assumptions, and also to his criticism that the majority opinion related future estimates of corporate earnings to the past record of consolidated earnings. The dissenting opinion emphasized the fact that in prior years the corporate earnings have been substantially less than consolidated earnings. However, the past record of the relationship between corporate and consolidated earnings is not necessarily the significant index for the future. Completion of the statutory simplification program will remove dividend blocks which have prevented the passing up of dividends of Railways' subsidiaries in the past and will restore managerial incentive so to do. Furthermore, any dividends not paid up will, as invested funds, produce earnings, and thereby increase system earnings.

As stated in the concurring opinion of Commissioner Burke (R. 36–37):

"Under these circumstances, as the participation of the common approaches zero, we are warranted in considering increasingly liberal assumption in favor of the possibility that earnings may substantially exceed what may be characterized as 'reasonably foreseeable.' In other words, the possible (though unlikely) rather than the probable range of earnings may be taken into account * * * —whereas allotment of a more substantial participation would necessitate a more conservative appraisal. In view of these considerations I am unable to say that an allocation around 5% would be unfair."

The majority of the Commission expressed a similar thought in the portion of the opinion quoted in the text, pp. 19–21, *supra*.

must be applied with this end in mind. In this case we are dealing with the interest of a common stock which has a somewhat remote but nevertheless appreciable future interest in the earnings of the enterprise, and a preferred stock having a preferential but limited claim on earnings, which income preference is insufficient to absorb all of the estimated future income. While the preferred stock has a contractual right, *in the event of liquidation*, to a preferential claim on assets in an amount exceeding the value of Power's assets, it has no contractual right *to require* liquidation or other reorganization.[11] On the contrary, the common stock—apart from Section 11—has a contractual right to continue in the enterprise without interference and with a view to participating in earnings after satisfaction of the arrears of cumulative preferred dividends.

It is in this setting that the fair and equitable standard must be applied. Looking at the operation of the statute as a whole—the requirement for reorganization, plus the plan of compliance—it seems clear that preferred and common stockholders are receiving the equitable equivalent of their entire respective bundles of rights surrendered. Petitioner argues that Section 11, or the prior order of the Commission, destroyed the

[11] Nor does it appear that there are equitable grounds which would entitle preferred stockholders to apply for a receiver to liquidate Power. Cf. *S. E. C.* v. *Fiscal Fund, Inc.*, 48 F. Supp. 712 (D. Del. 1943).

common stockholders' right to "keep going," and matured the otherwise inchoate liquidation preference of the preferred stock, and did so without possibility of compensation to the common stockholders. On that basis petitioner claims for the preferred stock the entire value of the enterprise. But Congress, in requiring the simplification of holding company systems, coupled with that requirement a provision for fair and equitable reorganization plans. Since the very purpose of doing so was to prevent the destruction of any legitimate investment values inherent in the existing structures, the Commission was warranted in measuring the treatment of preferred and common stockholders in the plan in the light of their existing status—apart from the operation of the statute. It was not required to treat the statute as adding new values to the preferred stock at the expense of the common—and then to treat this new status as the point of departure from which to measure the fairness of the plan.

Since the standard applied by the Commission fully recognizes the "absolute priorities" of Power's preferred stockholders in their relevant context, it is entirely consistent with the bankruptcy reorganization and equity receivership precedents dealing with matured claims.

It is immaterial that the instant plan happens to involve a liquidation, rather than employs some other procedural device which would not come

within the letter of the preferred stockholders' charter liquidation preference. The essence of the reorganization process is the remolding of contract rights and the substitution therefor of equitable equivalents. Here "liquidation" of Power as a corporate entity happens to be the most convenient procedural mechanism to accomplish the necessary reorganization. It is sufficient that both classes of Power's stock receive continuing interests in the same underlying business enterprise in proportion to their existing stakes in that enterprise. The "fair and equitable" standard must be applied in the light of what the plan does to the security holders affected, rather than in such a way as to require different relative participations depending on the procedural mechanics of the reorganization.

ARGUMENT

I

THE "FAIR AND EQUITABLE" STANDARD OF SECTION 11 (E) REQUIRED THE COMMISSION TO MEASURE THE RESPECTIVE PARTICIPATIONS OF POWER'S PREFERRED AND COMMON STOCKS IN THE REORGANIZED ENTERPRISE IN THE LIGHT OF THEIR RESPECTIVE BUNDLES OF RIGHTS AND NOT SOLELY ON THE BASIS OF THEIR LIQUIDATION PREFERENCES

1. Relation of the "fair and equitable" standard to the statutory scheme

(a) Conditions which Section 11 was designed to meet.

As expressly stated in Section 1 (c), the Act was passed "to meet the problems and eliminate the evils" enumerated in Section 1 (b):

> and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

Thus, the integration and simplification provisions of Section 11 were declared to be the very heart of the Act.[12] Reference to the condition of the holding company industry at the time of the passage of the Act will readily indicate why this was so.[13]

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[12] The Senate Committee Report stated (S. Rep. 621, 74th Cong., 1st Sess., p. 11):

"As has been pointed out above, the purpose of section 11 is simply to provide a mechanism to create conditions under which effective Federal and State regulation will be possible. It is therefore the very heart of the title, the section most essential to the accomplishment of the purposes set forth in the President's message."

[13] That condition had been the subject of the voluminous Federal Trade Commission Report, *Utility Corporations*, 70th Cong., 1st Sess., Senate Document 92. This report and that of a House Committee are referred to in Section 1 (b) of the Act. A summary of the Federal Trade Commission findings appears as No. 72-A of its Report (hereinafter cited as "Utility Corporations, No. 72-A"). See also Barnes, *The Economics of Public Utility Regulation* (1942), pp. 61-148, 671.

The period of the late 20's and early 30's had been characterized by a mushroom growth of holding companies, and in consequence at the end of this period the typical holding company system controlled a group of scattered public utility companies with no operating relationship to each other, and had a security structure of great complexity. In this expansion, several layers of holding companies were "pyramided" on top of the ultimate revenue-producing operating subsidiaries and there were typically two or more different classes of securities outstanding at each level in the pyramid. Promoters' hopes had been predicated on the hypothesis that earnings at each level in the pyramid would exceed the cost of "senior money" as represented by the interest charges payable on publicly held debt securities and the dividend requirements of publicly held preferred stock. Thus, because of the "leverage" aspects of the security structure, expectations had been aroused of receiving an ever increasing rate of return on the ultimate equity security at each level of the pyramid.[14] Under boom-time psychology this was frequently regarded as a desirable characteristic insofar as the holders of equity securities were concerned, and the prices of such securities rose to fan-

[14] For further explanation of the "pyramiding" aspect of holding company security structures: see *Utility Corporations*, No. 72–A, pp. 157–166, 858–859, and see Barnes, *The Economics of Public Utility Regulation*, pp. 73–84.

tastic levels.[15] The risk factor was overlooked. Purchasers of holding company bonds and preferred stocks which, because of their limited claim on earnings, obtained little of the possible advantages of such leverage, nevertheless bore the bulk of the risk because they had contributed most of the capital at stake. The leverage factor also tended to magnify the consequence to all holding company security holders of misleading accounting practices of the period.[16]

With the advent of the depression the earnings of the operating companies, particularly the electric utility subsidiaries, held up relatively well.[17] Nevertheless, there was a spectacular collapse in market prices of holding company

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[15] Hearings before Committee on Interstate and Foreign Commerce on H. R. 5423, 74th Cong., 1st Sess. (1935), at p. 2090.

[16] "It has been found that it is quite a common practice among holding companies to overstate earnings and surplus by recording unrealized earnings. The usual ways of doing this are through counting as income intercompany profits, undistributed earnings of subsidiaries, and the erroneous recording of stock dividends, stock rights, etc., received. The creation of surplus by the inflation or write-up of assets has been very general.

"With respect to operating companies, the usual methods of overstating surplus are through inadequate provisions for depreciation, revaluations of fixed assets, and the improper capitalization of expenses." *Utility Corporations*, No. 72–A, pp. 514–515. See also pp. 528–533, 868–870.

[17] As a whole, the electric utility industry had greater gross revenues in 1936 than it did in 1929. See "The Electric Light and Power Industry in the United States," Edison Electric Institute Statistical Bulletin No. 9, 1941, at p. 39.

securities of all classes. It was then for the first time brought home to the average investor in the common stocks of holding companies that leverage operates both ways. Many holders of holding company bonds and preferred stocks in turn realized for the first time that what they had really purchased was in the nature of a limited dividend common stock.[18]

Some of the major holding company systems, of course, went into bankruptcy and to the extent that this was so, there was the possibility of reorganization in the bankruptcy proceedings. However, in many other instances the immediate cause of the financial difficulty was not primarily excessive amounts of debt securities but excessive amounts of preferred stock at various levels in the financial pyramid. There were widespread failures of such holding companies to maintain dividend payments on their preferred stocks.[19]

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[18] See testimony of Commissioner Healy in Hearings Before House Committee on Interstate and Foreign Commerce on H. R. 5423, 74th Cong., 1st Sess. (1935), at p. 212.

"Commissioner HEALY. That is right. That is, you have the spectacle of people buying preferred stock in a holding company saying that they would not touch a common stock with a 10-foot pole, and when they look into the portfolio of the holding company and its assets, they see that they are common stocks, and they have bought common stocks without knowing it. And, the same thing is true of bonds. They rest upon those stocks."

[19] As the Commission has stated in its Ninth Annual Report to the Congress (at p. 25):

"As of December 31, 1938, holding companies registered under the Holding Company Act had outstanding $2,450,-

Arrearages were caused in part by an actual insufficiency of current income of the system and in part because it became impossible to bring up more than a small proportion of the consolidated income to the top holding companies. Inability to distribute income was due both to recognized impairments of capital, which created blocks to the upward flow of income otherwise available, and also to the difficulty of selling additional securities for plant additions which were needed by the operating companies to meet a continued increase in demand for electricity. Where new securities could not be sold the operating companies were compelled to withhold dividends and reinvest their earnings in capital additions.

With respect to this problem of raising new capital it should be noted that the holding company securities had lost their glamour, and had become difficult to sell. Moreover, when it came to considering holding company legislation, even the holding company spokesmen did not seriously question the advisability of regulation which might prevent future issues of the types of holding company bonds and preferred stocks that had

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000,000 of preferred stocks. Of this total, more than half, or $1,400,000,000, was in arrears in dividends, the total accumulated arrearages being some $363,000,000. Even many utility operating companies were so overcapitalized that they could not meet their preferred dividends. Of $1,750,000,000 of preferred stocks of operating companies, approximately $500,000,000 were in default, the arrearages aggregating $148,000,000."

been so widely distributed in the promotional era.[20] In fact Sections 7 (c) and (d) of the Holding Company Act provide that only under narrowly defined exceptions may holding companies issue anything but common stocks for new capital. The fantastic financial superstructure which had been imposed upon an operating industry which was recognized to be of vital public importance and, as well, to be capable of affording a sound medium for investment, thus pointed to the need of a sweeping reorganization of the industry.

(b) Recommendations of National Power Policy Committee

The general outlines for the holding company legislation took shape in a report of the National Power Policy Committee on Public Utility Holding Companies, which was transmitted by the

[20] Indeed, the only qualification which the holding company spokesmen made with respect to the regulation of the types of securities which should be permitted to be issued in the future, was that the Commission should have more discretion in the matter than was envisaged by the proponents of the legislation. See statement of Wendell L. Willkie (then President, Commonwealth & Southern Corporation), Hearings Before the Committee on Interstate Commerce, United States Senate, 74th Cong., 1st Sess., on S. 1725, pp. 598, 613–614; statement of James F. Fogarty (then President, North American Co.), Hearings Before the Committee on Interstate and Foreign Commerce, House of Representatives, 74th Cong., 1st Sess., on H. R. 5423, Pt. II, p. 993; statement of Henry L. Harriman (former President, United States Chamber of Commerce, associated with New England Power Association), *ibid.*, Pt. II, p. 1559–1560.

President to the Congress in his message of March 12, 1935, and which served as a blueprint for the drafting of holding-company bills.[21] We quote below the recommendations of that Committee insofar as pertinent to Section 11:

> We therefore recommend Federal legislation regarding public-utility holding companies. Such legislation should eradicate disclosed abuses, prevent the use of the holding company and affiliated interests to obstruct State regulation of operating companies, and make possible the elimination of the holding company where it serves no demonstrably useful and necessary purpose, without undue dislocation of investment or the loss of operating economies which flow from economically and geographically integrated public-utility systems.
>
> 1. The ultimate purpose of the legislation should be the practical elimination within a reasonable time of the holding company where it serves no demonstrably useful and necessary purpose. But the amount of reorganization, transfers of assets, and distributions in dissolution required for the dismantling of our huge holding-company systems is so great that the task of elimination cannot be accomplished in a year or two without possibly too great sacrifice of apparent values. Furthermore, it seems administratively advis-

[21] See S. Rep. No. 621, 74th Cong., 1st Sess., pp. 55–60. For the convenience of this Court we have reprinted this report as Appendix B to this brief.

able that every opportunity be offered the owners of holding-company securities to work out their own processes of dismantling. That opportunity should, of course, be vigilantly guarded to protect the average investor from the exploitation threatening him almost as a matter of course under our usual methods and mores of corporate reorganization. In destroying the abuses of the holding companies, the Government must not leave great groups of helpless investors to the certain abuses of extensive hurried corporate reorganizations. The dominant groups who have ruthlessly plucked the investor in promoting some of these huge holding companies must not be allowed to pluck him again as reorganization managers.

On the other hand, if the disappearance of the holding-company excrescence is to be realistically expected at the end of a given period, there must be a constant pressure on the managers of holding-company enterprises, persistent from the very beginning of that period, to insure a continual process of whittling down complicated capital structures and of disassociating operating properties not related to each other geographically or economically. Only such a continual process can guarantee that at the end of the given period the holding companies will have been dismantled into organizations simple enough in structure to be readily dissolved if they are to dis-

solve, or sufficiently shrunk and integrated for operating purposes so that they may readily be transformed into operating companies. Without such a dismantling process holding-company liquidation at the end of the period may well cost the same sacrifice of investors' interests as would be required to effect their liquidation a year from today. The devices recommended below are devices to effect that continual pressure to compel that continual dismantling process.

2. To attain the flexibility desirable for the handling of this complicated problem in a realistic and prudent way, Federal control should be vested in an administrative commission.

* * * * * *

11. The Commission should study existing systems so that they may be simplified by the elimination of unnecessary corporate complexities and of properties which do not fit into an economically and geographically integrated whole. Simplification and reorganization of holding-company structures, making possible within a reasonable period the practical elimination of the holding company, should be conducted under the Commission's supervision over a period of time to prevent undue losses to security holders from investment dislocations. Voluntary action by the companies should be encouraged as much as possible, but the commission should be empowered

to issue orders compelling necessary divestments, dissolutions, and reorganizations. Such orders should be enforceable in the courts and the commission should act as trustee to effectuate necessary divestments, reorganizations, or dissolutions.[22]

(c) Intention that the reorganization provisions of Section 11 should bring about simplification of holding company systems without destruction of legitimate investment interests

After the drafting of bills which embodied the substance of the recommendations of the National Power Policy Committee, a controversy developed which focused primarily upon the provisions of Section 11. The heart of this controversy, as recognized by both opponents and proponents of the Act, was whether complex holding company systems could be "unscrambled" without causing additional losses to the investors who, as the National Power Policy Committee Report stated, had already been "ruthlessly plucked" (*supra*, p. 33) in the promotion of the holding companies. The epithet "death sentence", referred to by petitioner (e. g. Br., p. 17), was repeatedly

[22] Other recommendations included (1) providing tax incentives for simplification of holding-company systems, and (2) authorizing the Commission itself to institute bankruptcy reorganization proceedings for insolvent holding-company systems. The latter recommendation was reflected in the earlier holding-company bills but the Act as passed contains no provisions authorizing the Commission to institute bankruptcy proceedings.

used by the opposition to suggest that the termination of the existence of corporate entities, however useless and cumbersome they might be, would necessarily involve destruction of investment values. This charge was emphatically rejected by the proponents of the Act.[23]

One specific answer was that the reorganization safeguards of the Act would fully protect all "legitimate investment interests." Thus a Senate committee report concluded a detailed exposi-

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[23] See, for example, Senate Report No. 621, 74th Cong., 1st Sess., at p. 11, wherein it is said:

"There has been much misunderstanding of the provisions of this section in the bill originally introduced (S. 1725). It has erroneously been called a 'death sentence' upon all public-utility holding companies. It has erroneously been charged that it would confiscate the investment of the public in the utility industry. For these reasons particular explanation of this section appears in this report."

The President's message of March 12, 1935, which is printed in S. Rep. 621, 74th Cong., 1st Sess., at p. 2, states with reference to the original holding company bill as introduced in both Houses:

"* * * Such a measure will not destroy legitimate business or wholesome and productive investment. It will not destroy a penny of actual value of those operating properties which holding companies now control and which holding company securities represent insofar as they have any value. On the contrary, it will surround the necessary reorganization of the holding company with safeguards which will in fact protect the investor."

In a radio address of the President, delivered April 28, 1935, and quoted at page 3 of the same report, the President concluded with reference to the bill: "remember that it will not destroy legitimate values."

tion of the reorganization provisions of the statute by stating (S. Rep. No. 621, pp. 16–17):

> As has been explained above, the title does not require the dumping or forced liquidation of securities. Such disposition as may be necessary can be accomplished by reorganization which will equitably redistribute securities among existing security holders. * * *
>
> The individual investor in present-day holding companies should come out of any reorganization process under the title with far better securities than those with which he went into it. He should get a security which represents an actual down-to-the-rails investment in a regulated local operating company, or, at most, a regulated regional holding company. * * * The actual clearing up, through clean reorganizations, of the tangle in which holding-company finance has left the industry and those who have invested in it, can reestablish a confident, stable market for good utility securities. * * *

Once there should be provided both enabling machinery and ultimate coercive sanctions it was hoped that the public utility industry itself would be the major force in working out methods of compliance. In that connection Congressman Eicher said:

> If the compulsions of the act are made sufficiently clear to convince the interlocking lawyers of the holding-company bank-

> ers that it can't be evaded or compromised, the legal and economic imagination which put these holding-company combinations together will devise many means of taking them apart. But pending the certainty of such compulsions the legal and financial advisers of the holding companies have not been concerned to discover how the proposed legislation will work; they have only been concerned to discover reasons why it won't work.[24]

It was believed that the equity precedents in connection with antitrust decrees afforded useful analogies as to how it might be possible to remold the security holders' rights to accord with the statutory policy without destroying values. It was emphasized that under these precedents there was no necessity for maturing liquidation preferences. See, for example, the following excerpt from Congressman Ficher's "additional views" appended to the House Report to accompany S. 2796:

> Long ago, under the Sherman Antitrust Law and under the commodities clause of the Hepburn Act, the courts worked out a

[24] House Report No. 1318, at page 50; Senate Report No. 621 also stated, at page 13:

"There are many forces at work in the industry which, given the machinery and the encouragement of legislation, will undertake to set their houses in order in enlightened self-interest in the same way that groups in the field covered by the Securities Exchange Act have undertaken reforms without compulsion within the framework of that act."

technique which would permit readjustments and reorganizations, *without the acceleration of indebtedness or the maturing of rights upon liquidation,* to enable corporations to rearrange their corporate structures and divest themselves of properties to the extent required to comply with Government policy. The courts have even gone so far as to permit the equitable apportionment among several properties of a general mortgage lien theretofore attaching to those properties as an indivisible whole, without accelerating the maturity date of the mortgage, if the segregation of those properties is necessary to conform to the policy of the Federal statutory law (*Continental Insurance Co.* v. *U. S., Reading Co., et al.,* 259 U. S. 156). The allegation that the Senate bill will cut off valuable equities by the forced liquidation of assets and the dumping of securities upon a demoralized market are consequently not borne out by the provisions of the Senate bill or the judicial precedents established in analogous cases. [Italics added.] H. R. Rept. 1318, 74th Cong., 1st Sess., at pp. 49–50.[25]

[25] See also S. Rep. No. 621, 74th Cong., 1st Sess., at p. 33, wherein it is stated with reference to Section 11 (e):

"Thus the voluntary reorganizations of the holding companies might be facilitated by the recognized powers of a court of equity to make such equitable allocations of general liens and priorities as may be necessary to make it possible for the companies to comply with the policy of the stat-

As the foregoing excerpts from the legislative background indicate, the proponents of Section 11 intended that the Commission, with the aid of the federal courts, should have a mandate to bring about an industry-wide reorganization in an extraordinarily complex field and to do so in such a way as not to destroy values, but rather to safeguard the legitimate investment interests of every class of security holders affected. To the Commission this mandate requires an interpretation of the "fair and equitable" standard in such a way as to take into account the operation of Section 11 as a whole and to give recognition to the entire bundles of security holders' rights affected. Therefore, to avoid robbing Peter to pay Paul, the Commission does not treat as ma-

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ute (*Continental Insurance Co.* v. *U. S., Reading Co., et al.*, 259 U. S. 156)."

At a later point in our brief we deal with petitioner's contention that the *Reading* case *requires* treating preferred stockholders' liquidation preferences as matured in a Section 11 (e) reorganization. Irrespective of our difference with petitioner as to what might be the proper application of the *Reading* case if this were a plan to comply with the antitrust laws, we believe it significant to note from the excerpt in the text that Congress in referring to the *Reading* case regarded it as a precedent for a flexible technique for working out plans of compliance by which it would be possible to avoid "the acceleration of the indebtedness or the maturing of rights upon liquidation" where to do so would frustrate the policy of preserving legitimate investment values.

tured otherwise unmatured liquidation preferences. This is the theme of our subsequent argument.

2. For the purpose of determining whether Power's preferred stockholders were fully compensated in the plan, the Commission properly treated their otherwise inchoate liquidation preference as not matured by the processes of Section 11

(a) The test of fairness applied by the Commission prevents the processes of Section 11 from appropriating the legitimate investment interests of either class of stockholders for the benefit of the other.

The Commission stated in its opinion (R. 13) that—

> in reorganizations or liquidations to comply with Section 11, stockholders affected should be given participations according to their contractual or other rights determined *as though in a continuing enterprise*, and that the process of compliance with the statute should not be permitted to mature liquidation preferences.

If the process of bringing the United Light and Power Company holding company system into conformity with the standards of the Act were considered as maturing the liquidation preferences of the preferred stock of Power, the result would be to transfer value from the common to

the preferred stock. Apart from the Act, the common stockholders have a right to remain in the corporation, and to have the system's earnings applied, first, to pay current dividends and the arrears on the preferred stock, and then to the payment of dividends on the common stock. The factual analysis which was summarized in an earlier part of this brief indicates that this right of Power's common stock was a valuable right, i. e., that the estimated future earnings of Power's system are sufficiently great so that the common stock would in fact receive dividends in the future. If it were held, however, that the preferred stockholders were entitled to all of Railways' stock, this valuable right of the common stockholders would be destroyed and this by operation of the Act. Such a determination would be plainly inconsistent with the intent of Congress that the statute should not destroy any legitimate investment values, or cause further loss to security holders. The intent of Congress could be satisfied only by permitting the common stockholders of Power to participate in the system's rehabilitation, since those common stockholders have a legitimate investment interest in the system.

The patent unfairness of treating a liquidation preference as the sole measure of the value of the respective rights of preferred and common stockholders becomes even more apparent when we consider the impact of such a test in situations

where there are no preferred dividend arrears, but nevertheless the assets do not exceed the amount of the liquidation preference. Assume, for example, that a holding company, free from debt, has outstanding $10,000,000 par value of 6% cumulative preferred stock, with a preferred dividend requirement of $600,000 per year. Assume that the liquidation preference of this stock is also $10,000,000 or par. Assume further that the company has $900,000 of earnings which, in the light of the risks of the business, should be capitalized on a 10% basis.[26] This would indicate a value for the business of $9,000,000. Petitioner's test would note the $9,000,000 valuation of the assets and the $10,000,000 liquidation preference of the preferred stock, and would give all the assets to the preferred stockholders. But no one would seriously contend that the common stock of the hypothetical company, earning $300,000 per annum (the difference between the $900,000 of earnings and the $600,000 dividend preference of the preferred stock) had no value. Yet petitioner's test would require the Commission to treat such a common stock as having no value for purposes of a Section 11 (e) plan.[27]

[26] This was the percentage used, as a minimum, by the dissenting commissioner as applicable to the estimated income of Railways in the instant case (R. 56).

[27] See Latty, Fairness—the Focal Point in Preferred Stock Arrearage Elimination (1942), 29 Va. L. Rev. 1, 26–27:

"And it is questionable that value of an equity in a going concern is to be determined by a uniform capitalization ratio

If we add to this example the fact that there are accumulated dividends on the preferred stock, the analysis becomes more complex, but the conclusion is unchanged; there is still a value for the common stock resulting from its ultimate residual interest in earnings. When there are arrears, the value of the common stock is reduced because its right to earnings will not come into enjoyment until all accumulated dividends on the preferred stock have been paid. But even where arrears are substantial, the common stock retains its contractual right to continue in the corporation so long as it appears that foreseeable future earnings will be sufficient to pay off the arrearages and permit the payment of dividends on the common stock. In appraising this possibility of ultimate resumption of common-stock dividends in a particular case it must be recalled that the accumulated arrears are a non-interest-bearing claim.[28]

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of net income. Otherwise, pushing this theory to a logical (though academic) conclusion: Assuming 10 as a proper capitalization ratio, if I borrow $1,000,000 at 5% and put in $1,000,000 of my own, and make $100,000 net profit per year, there is, under this theory no value existing for my holdings in the enterprise; yet common sense tells us that I have a valuable interest there."

Further illustration of the difficulties with petitioner's test is that it would require the same treatment for a $4 and a $7 dividend stock of equal rank, assuming both have equal liquidation preferences.

[28] In this case Power's liquidation preference consists of (1) an initial preference of $100 per share, which is in effect the base for a 6% annual cumulative dividend claim, plus

In the present case this residual interest of the common stock cannot be ignored unless its prospect of coming into enjoyment is so remote as to make its value negligible (see note 40, *infra*). As we have seen, the factual analysis made by the Commission convinced it that, apart from the statutory requirement for reorganization, Power's common stock would ultimately participate in earnings under the existing structure. Conversely, the same factual analysis indicates that Power's preferred stock, with its limited dividend rights, and merely inchoate liquidation preferences, could not have expected to receive 100% of the future earnings. To the extent that the plan eliminated the common stockholders' residual claim to all earnings after satisfaction of the dividend preference of the preferred stock it conferred positive benefits upon Power's preferred stockholders just as clearly as it likewise conferred benefits upon the common stockholders in permitting them to share in current earnings.

Petitioner's analysis of the problem completely ignores the advantages which Power's preferred stockholders received in the elimination of 95% of the common stockholder's residual claim to income. This is because petitioner would require

(2) $64 of accumulated arrears. Using the liquidation preference as the sole test of the preferred stockholder's claim would require the same compensation for the non-interest-bearing arrears as for the initial $100 claim with its $6 annual dividend charge.

the Commission to treat the preferred stockholder's inchoate liquidation preference as having fully matured before the Commission could begin to weigh the fairness and equity of the plan. Petitioner would thus have the scales of equity weighted in advance in favor of the preferred stock by adding to their pre-existing bundle of rights the statutory requirement for reorganization.[29]

Only by this assumption can petitioner argue that "fairness and equity" require allocation of all assets to the preferred stockholders wherever the present value of the assets is less than the face amount of that liquidation preference and despite the fact that, apart from the statute, common stockholders would have a legitimate expectation of participating in future income. To hold with petitioner that the Act was intended to work such a transformation in the relative

[29] In this instance the statutory obligation to simplify the Power system was implemented and given specific form by the Commission's order of March 20, 1941. In the next section of this brief we indicate the reasons why we regard it as immaterial, in applying the fair and equitable standard here, that this order and the subsequent plan of compliance therewith may have made literally applicable the stipulated liquidation preference of the preferred stockholders when it envisaged the elimination of Power as a separate corporate entity in the system. While petitioner's argument is predicated in part upon the particular nature of the order and plan in question, the broader implications of the argument must rest essentially upon the statutory requirement for reorganization itself as the basis for maturing otherwise inchoate liquidation preferences.

rights of preferred and common stockholders is to hold that it confers a windfall on the preferred stock at the expense of the legitimate investment stake of the common stock.

The Commission rejected any such hypothesis on the ground that it would prevent realization under the Act of the kind of a rehabilitation of investors' interest which Congress had intended. As to this the Commission stated (R. 14-15):

> Clearly the intent of Congress was that the techniques employed under Section 11 should be those necessary to remove the holding-companies' concentration of economic power over operating utilities, promote local management and regulation for the benefit of consumers, eliminate unnecessary and uneconomic corporate entities, and benefit investors generally by giving them more direct interests in the operating properties and earnings *to the extent that their holding-company securities represent any real equity therein.* The liquidation of Power accomplishes an important step in this direction by giving the preferred and common stockholders a security that is better than those they have heretofore held. This process of improvement of position must not be permitted to destroy any legitimate interests of the common stock, or present a windfall to any senior security.[30]

[30] There have been omitted from the above quotation footnote references to the legislative history which we have discussed above.

The standard which the Commission thus applied in this case has been consistently applied by the Commission to all types of readjustment of stockholders' rights pursuant to the requirements of Section 11.[31] The Commission's interpretation of Section 11 (e) has been upheld by every court that has thus far had occasion to review the Commission's action.[32]

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[31] *Community Power and Light Company*, 6 S. E. C. 182 (1939), enforced 33 F. Supp. 964 (S. D. N. Y., 1940); *Federal Water Service Corp.*, 8 S. E. C. 893 (1941), remanded on another point *sub nom. Securities and Exchange Commission* v. *Chenery Corp.*, 318 U. S. 80 (1943); *Puget Sound Power & Light Co.*, Holding Co. Act Rel. No. 4255 (1943), enforced without opinion, D. Mass., unreported, 1943; *Southern Colorado Power Co.*, Holding Co. Act Rel. No. 4501 (1943), enforced without opinion, D. Colo., unreported, 1944, appeal pending *sub nom. Disman* v. *Securities and Exchange Commission*, C. C. A. 10, 1944; *Virginia Public Service Co.*, Holding Co. Act Rel. No. 4618 (1943); *International Utilities Corporation*, Holding Co. Act Rels. Nos. 4896, 4992 (1944), enforced without opinion, S. D. N. Y., unreported, 1944; *Laclede Gas Light Co.*, Holding Co. Act Rel. Nos. 5062, 5071 (1944), enforced E. D. Mo., 1944, opinion approving plan not yet reported.

[32] District court decisions are included in the preceding footnote. Petitioner in the court below placed great emphasis upon the district judge's reliance on this Court's decision in *Securities and Exchange Commission* v. *Chenery Corp.*, 318 U. S. 80 (1943), and particularly upon his reliance on the language of Mr. Justice Frankfurter with reference to the "fair and equitable" standard in Section 11 (e):

"Determination of what is 'fair and equitable' calls for the application of ethical standards to particular sets of facts. But these standards are not static. In evolving stand-

(b) There is no substance to petitioner's suggestion that the test of fairness applied here is unsound because of supposed difficulties in applying it to other types of problems

Despite this consistent course of administrative and judicial procedures applying the "fair and equitable" standard in contexts similar to the instant case, petitioner seeks to establish inconsistency in action taken or imagined, based upon other types of cases, both actual and hypothetical. While we question the relevance of this line of inquiry we summarize below the extent that the Commission has thus far come to grips with the type of problems posed by petitioner.

(i) Petitioner urges "Certainly if the preferred stockholders in the instant case had held bonds calling for a payment thereon equal to the par value and accrued interest upon a liquidation, before the common stock received anything, the contract would be recognized and the Plan denounced as not being fair and equitable" (Br., pp.

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ards of fairness and equity, the Commission is not bound by settled judicial precedents. * * *"

The Commission did not rely on the *Chenery* case in its opinion. As we understand it, that decision merely emphasizes the propriety of considering the "fair and equitable" standard in its statutory context (and in the light of an initial exercise of administrative judgment as to the proper application of the standard) rather than of trying to find the answer to a special statutory problem in judicial precedents adopted in different contexts. The Circuit Court of Appeals considered that the *Chenery* case "is not precisely apposite" (R. 137).

14–15). This, however, is an unlikely as well as an oversimplified hypothesis. If Power's preferred stock had been the ordinary type of fixed interest debentures the answer is, of course, that Power would have been in bankruptcy long prior to the Holding Company Act. If the facts were changed and the default under the indenture did not become imminent until after the effective date of Section 11 (e), and the Section 11 (e) plan had been filed as a procedural alternative to proceeding under Chapter X, then the Commission would have treated the debt as a matured claim in all respects as though the plan were to be accomplished in a bankruptcy proceeding.[33] If, however, what petitioner supposes is a freak security, called a bond, which carries an interest charge payable only in the judgment of the board of directors, and the principal obligation of which has either no maturity date or a very remote one, then the security would appear to be in all respects except in name a preferred stock. Whether the mere fact that such a security was labeled a "bond" or "debenture" should be regarded as of any significance for purposes of reorganization is a problem the Commission has never had occasion to consider.[34]

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[33] See note 46, *infra*.

[34] Nor has it had occasion to consider the status of an income bond of the type which this Court dealt with in *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106. Conceivably in dealing with such an income bond the question

(ii) Petitioner also urges that the Commission's action in the instant case is inconsistent with its earlier order approving the application by Power of the proceeds of disposition of certain of its assets to the prepayment, without a premium, of Power's then outstanding debentures. That action was affirmed in *New York Trust Company* v. *S. E. C.*, 131 F. (2d) 274 (C. C. A. 2), certiorari denied, 318 U. S. 786, rehearing denied, 319 U. S. 781. We submit that no such inconsistency exists. In fact, while the dissenting Commissioner relied on the prior decisions in the premium cases, the majority found support in the same decisions for its approval of the instant plan.

Both the Commission and the circuit court of appeals decisions in that case held (1) that the indenture provision permitting the company to call the debentures for retirement at a premium was inapplicable under the circumstances, and (2) treating the contract provision for prepayment as inapplicable, the circumstance that compliance with Section 11 had compelled the sale of certain properties (leaving Power with no further use for the capital contributed by the

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whether it should be treated as a presently matured claim might turn on whether the company were found to be insolvent. It should also be noted that if the contract maturity date were a relatively near one, it might make little difference, for the purpose of determining the participation rights of the holder of the income bond, whether the contract date were adhered to or maturity accelerated.

debenture holders), made applicable the doctrine of "frustration of the venture." Under that doctrine Power was not obliged to continue paying for hire of funds for which it had no further use.[35] No attempt had been made on behalf of the debenture holders to establish that their interest in Power as a continuing enterprise was worth more than the face amount of their claim. Accordingly, there was at least as good ground for assuming that payment of a premium would be a windfall to debenture holders as that the ability to discharge the debt at its face amount in advance of maturity might be regarded as a windfall to Power's stockholders.[36]

The Commission has not treated the *New York Trust Company* case as providing a complete answer to all the problems that may be presented by plans which contemplate prepayment of debt. In subsequent cases the Commission has frequently emphasized the circumstance, not

[35] In the case of the premium on Power's debentures, there was, *pro tanto*, a liquidation in a broader sense than is involved in the instant plan, since the source of the funds used to prepay the bonds was primarily the proceeds from sales of properties made necessary by Section 11 (b) of the Act.

[36] In the Commission's brief in the circuit court of appeals in the *New York Trust Company* case it was urged that there was affirmative basis in the record for concluding that, apart from the necessity of compliance with Section 11, Power's debentures were in a position of risk at least commensurate with the contract rate of interest, and that therefore there was no basis for claiming that they had been injured by the statutory processes which had compelled prepayment of their debt.

articulated in the *New York Trust Company* case, that an appraisal taking into account interest rate, maturity date, and risk factor incident to the particular debt security which is to be prepaid would indicate that payment of face amount, without a premium, would be full compensation for premature termination of the investment through the operation of the statute.[37] Where the transaction which results in prepayment of indebtedness (while part of the action necessary to comply with Section 11) may be regarded as in some respects in the nature of a refunding rather than a withdrawal of capital from the enterprise, it has seemed particularly important to enter into this appraisal of the going concern value of the creditor's investment contract.[38]

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[37] See *North Continent Utilities Corporation*, Holding Company Act Release No. 4686, p. 12 (November 18, 1943), plan enforced in *In re North Continent Utilities Corporation*, 54 F. Supp. 527 (D. Del. 1944) (emphasizing meager earnings coverage, unfavorable market history and doubts as to ability to meet maturity five years hence); *Consolidated Electric and Gas Company*, Holding Company Act Release No. 4900, pp. 4–7 (February 21, 1944), plan enforced in *In re Consolidated Electric and Gas Company*, 55 F. Supp. 211 (D. Del. 1944).

[38] In *Cities Service Power & Light Company*, Holding Company Act Release No. 4944, p. 16 (March 15, 1944), and *Laclede Gas Light Company*, Holding Company Act Release No. 5062, pp. 26–29 (May 24, 1944), plan enforced in *Matter of Laclede Gas Light Company*, E. D. Mo., August 25, 1944, not yet reported, where at least part of the funds for retiring outstanding securities came from new financing, no premium

(iii) Petitioner further criticizes the Commission's decision in this case on the ground that a consistent application of the standard of fairness applied here might require payment in excess of liquidation preference to a preferred stock which, apart from the requirements of Section 11 (b), would be regarded as worth substantially more than its liquidation preference; e. g., by reason of a high dividend rate which appears relatively free of risk in view of earnings and asset coverage (Br., p. 20). We would scarcely regard it as a valid criticism of the standard of fairness applied in this case, that it might under converse circumstances prevent common stockholders from obtaining through operation of Section 11 a windfall at the expense of preferred stockholders. There are, however, no relevant Commission precedents, and insofar as comparable problems may be envisaged in connection with situations which are under consideration by the Commission or its staff, there are

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was paid in view of the inferior character of the securities retired. Cf. *United Gas Corporation*, Holding Company Act Release No. 5271, p. 33 (September 8, 1944), where the outstanding preferred stock which was being retired out of the proceeds of the new issue was so well protected with respect to assets and earnings that the Commission found its retirement to be not attributable to the necessity of compliance with Section 11 (b), but rather to the common stockholders' desire to avail themselves of an opportunity to obtain cheaper senior money; the plan approved by the Commission provided for its retirement at the call price.

many complexities not included in the problem as posed by petitioner.

The fairness of a proposal to pay preferred stockholders the amount of a liquidating preference, which is less than the value of continuing in the enterprise with their existing preferential dividend claim, may depend on (1) whether the common stockholders have existing voting rights sufficient as a matter of general law to cause a liquidation, (2) whether there is any equitable reason for limiting the exercise of such voting rights, and (3) whether, as a matter of construction, the particular charter provision relied on to limit the preferred stock to its liquidation preference is in fact applicable.

Depending upon the resolution of such questions, it may or may not appear that there is a problem of measuring the impact of Section 11 upon the existing bundles of rights enjoyed by the preferred and common stockholders, respectively. It is scarcely profitable to anticipate the Commission's answer to problems so different from that involved in the present case and we refer to them only to illustrate how petitioner has oversimplified the problem it has suggested.

(c) The standard of fairness applied here is to be contrasted with the inadequate standard applied in readjustments under state laws

Returning to the problem with which we are here concerned, namely, readjustment of stock-

holders' rights where there are substantial preferred stock dividend arrears, we wish to emphasize one further point. The standard employed by the Commission should not be confused with the criteria often employed in recapitalizations under state law where common stockholders are frequently permitted to exact a toll for their consent to a much needed capital readjustment. Indeed, the Commission has had occasion to call attention to the unfortunate results often reached in typical recapitalizations under state law.[39]

One weakness of the applicable state law procedure is that it does not afford any compulsion for reorganization without the consent of specified majorities of the various classes of outstanding stock. Where there are current earnings and either a capital impairment, or sheer unwillingness on the part of common-stock-dominated directors to pay dividends, preferred stockholders are under strong pressure to pay whatever price may be necessary to purchase common stockholders' consent to any recapitalization which may lead to the resumption of dividends. Common stockholders' bargaining power is enhanced by the very fact that, in view of substantial arrears, there may be only a remote expectation of common stock dividends and thus the common stock-

[39] See Securities and Exchange Commission Report on Protective and Reorganization Committees Part VII, pp. 109–187.

holders have little to lose by "sitting tight." Such state laws moreover contain no express provision for judicial review of the fairness of a recapitalization plan and the only basis for challenging the plan is the bringing of an equity suit in which the plan may not be set aside unless it is established to be "so unfair as to amount to constructive fraud" (see *Hottenstein* v. *York Ice Machinery Co.*, 136 F. (2d) 944 (C. C. A. 3, 1943)). Even if the equity court were to attempt to subject the plan to a more exacting test of fairness, it would find itself in the dilemma of being able to veto the plan before it but of having no adequate means of compelling the common stockholders to consent to a fairer plan.

These deficiencies under the typical state incorporation laws are obviated where Section 11 of the Holding Company Act is applicable because the statute makes the necessary reorganizations compulsory and provides for both administrative and judicial scrutiny of the fairness of the plan. Accordingly in Holding Company Act reorganizations common stockholders are not allowed to capitalize on mere nuisance positions [40] or to exact a

[40] In *Federal Water Service Co.*, 8 S. E. C. 893, 914 (1941), and *Southern Colorado Power Co.*, Holding Company Act Release No. 4501 (1943), the Commission excluded from participation junior common stocks having no reasonable prospect of ever receiving dividends from the corporations.

toll for the surrender of inequitable voting rights as required by the Holding Company Act.[41]

Commentators who have considered the Commission's application of the "fair and equitable" standard to recapitalization plans have agreed that the standard applied by the Commission under Section 11 (e) is one which gives the preferred stockholders far better treatment than is customary in plans which are put through in

[41] In *Young* v. *Columbia Gas and Electric Corporation*, 129 F. (2d) 216, 220 (C. C. A. 3, 1942), the Third Circuit passed incidentally upon the fairness under State law of the proposed treatment of preferred and common stockholders in a plan for reorganization of Columbia Oil and Gasoline Corporation which the court recognized was still subject to Commission authorization pursuant to the Public Utility Holding Company Act. Afterwards that plan was abandoned and a different plan proposed which was regarded as far less favorable to common stockholders of Columbia Oil, and correspondingly more favorable to preferred stockholders, than the plan which had been before the Circuit Court of Appeals in the *Young* case. The new plan was approved by the Commission. The Commission indicated that in appraising the relative equities of preferred and common stock for purposes of Section 11 (e) it could not take into account potential weakness in the antecedent strategic position of the preferred stockholders owing to the possible abuse by the common stockholders of their voting rights, a circumstance which had been given weight in connection with the prior plan. The order of the Commission which affirmed the new plan for Columbia Oil was affirmed on review by the same court which had previously decided the *Young* case. See *Columbia Oil and Gasoline Corporation*, Holding Company Act Release No. 3886, pp. 26–27, order of Commission affirmed *sub nom. Marquis & Co.* v. *Securities and Exchange Commission*, 134 F. (2d) 822 (C. C. A. 3, 1943).

accordance with state law. See Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination* (1942), 29 Va. L. Rev. 1, 27–39; Dodd, *Fair and Equitable Recapitalizations*, (1942) 55 Harv. L. Rev. 780, 796–806, 816; and see also a subsequent article by Dodd reviewing the decision of the Commission and the district court in the instant case, entitled *The Relative Rights of Preferred and Common Shareholders in Recapitalization Plans Under the Holding Company Act* (1944), 57 Harv. L. Rev. 295.

Power's preferred stockholders have thus been greatly benefited by the mandatory requirements for simplification of the holding company system contained in Section 11. They have thereby been relieved from any necessity of paying a price to obtain common stockholders' consent to a much needed reorganization. They have had the further protection of the application by both the Commission and the district court of a far more sensitive appraisal of fairness than has hitherto been applied in recapitalizations not affecting creditors' rights. Instead of being satisfied with these tremendous benefits, petitioner seeks to make a fetish of a single one of the bundle of rights involved, namely, the liquidation preference. The Court is urged to hold that, unless preferred stockholders can be permitted to realize that liquidation preference in full, no plan is fair to them even though it gives them new securities

which fully represent, upon over-all analysis, their relative interest in the preexisting enterprise.

Such a holding would vindicate the defeatist attitude of those who claimed that it was impossible to simplify the holding company systems without destructive consequences to investors. It is not without significance that petitioner bases its argument on the hypothesis that Section 11 should be regarded as a "death sentence" (Br. 17). It is submitted that the Court should not construe the Act in a manner so clearly contrary to the intention of Congress.

3. The standard applied by the Commission fully recognizes the "absolute priority" of Power's preferred stock in its relevant context.

The Commission was, of course, fully conscious of this Court's holding in *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, that the words "fair and equitable" had come to be "words of art" as used in connection with reorganizations accomplished through equity receiverships, and that Congress must have used these words in Section 77B of the Bankruptcy Act as importing their historic meaning, and as therefore requiring recognition of "absolute priority" of senior interests.[42] For similar reasons the Commission construes the words "fair and equitable" in Section 11 (e) as requiring recog-

[42] It will be recalled that the Commission joined in a brief *amicus curiae* in support of the petitioner in that case.

nition of "absolute priorities." It does not regard the Act as a composition statute.[13] It is only with respect to the question of just what are the "absolute priorities" of Power's preferred stockholders for which they are entitled to be compensated, that there is any difference of opinion with petitioner or within the Commission.

Referring to Commissioner Healy's views, the majority of the Commission said (R. 16):

> It is pointed out in Commissioner Healy's separate opinion that the words "fair and equitable" embodied in Section 11 have a

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[13] Section 11 (e) contains no requirement for vote of security holders on a plan, and it is, of course, inconsistent with the affirmative requirements of Section 11 (b) that any class of security holders should have a veto on compliance with the statute. The present plan does not provide for any vote. Some of the plans which the Commission has considered under the standards of Section 11 (e) have provided for a vote of security holders. Indeed, a provision for a vote has been held an immaterial part of a plan, relating only to the mechanics of execution. For that reason a federal district court decreed enforcement of a plan that provided for a stockholders' vote in accordance with the State law, although there was an unresolved controversy as to whether the vote so obtained did meet the requirements of State law. See *Application of Securities and Exchange Commission*, 50 F. Supp. 965 (D. Del., 1943).

The Commission does not regard a provision for a vote as affecting the extent of its responsibility to be satisfied that the plan is fair to every interest affected. For similar reasons we do not concur in Power's emphasis (Br., pp. 5, 6, 27) upon the absence of any objection before the Commission to even the allocation proposed by Power. The Commission did not regard this absence of objection as relieving it from the duty of reducing the common stockholders' participation to the lesser amount which it regarded as "fair and equitable".

> settled meaning, as determined by the courts, and that an application of the "absolute priorities" doctrine must result in no distribution to Power's common stock in this case. But that is because he measures the rights of the preferred stock as they would be measured in bankruptcy cases, and not merely because he follows the "absolute priorities" doctrine in determining the consequences of the measurement. In other words, we can agree with him when he says that absolute priorities must be respected, because we think that doctrine simply means that the common stock must not be accorded any participation unless the preferred stock has been fully compensated for its rights and priorities. But there the area of agreement stops, because he says further that the rights and priorities of the preferred stockholders are the same here as in bankruptcy cases, where their claims to liquidation preferences (including dividend arrearages) are treated as matured. In our view it would be unconscionable and contrary to the plain intention of Congress to so hold.

The basis upon which the majority concluded that the Section 11 (e) reorganization process should not be treated as maturing Power's liquidation preference and that in that respect the equity and bankruptcy precedents are inapplicable is that the latter precedents (R. 12)—

> are predicated on sets of facts fundamentally distinguishable from the situation

> arising here. In bankruptcy or equity reorganizations * * * Creditors and other claimants are prevented from foreclosing or otherwise compelling an actual liquidation, but new securities are distributed among them according to their contractual and other rights determined *as though in liquidation.* * * *
>
> On the other hand, Power is a company virtually without debt and under no financial embarrassment in the traditional bankruptcy or equity sense.

As the Commission indicated, there is a substantial difference between the impact of the Section 11 (e) reorganization process here and the typical situation in a bankruptcy reorganization. In bankruptcy reorganization the compulsion for change comes from a debt default (existing or prospective) and from the ability of the creditors to force action.[11] It is because the bankruptcy

[11] Petitioner urges that there is no real distinction between reorganizations under the Act and bankruptcy reorganizations, and particularly that *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, dealt with the rights of stockholders vis-a-vis holders of income bonds which had not matured prior to the institution of the proceedings. However, the company had filed a voluntary petition under Section 77B and had admitted therein its insolvency, thereby invoking the ordinary bankruptcy principle which permits proof of claims whether matured or unmatured. The particular language from this Court's opinion quoted at pages 18–19 of petitioner's brief, read in its context, indicates only that a company filing a voluntary petition under Section 77B, and admitting its insolvency, cannot exact a price for that admission so as to entitle stockholders to a participa-

reorganization procedure is regarded as a statutory short-cut to the result which might have been reached by judicial sale that the equity receivership precedents have been regarded as fully applicable to the Bankruptcy Act test of "fair and equitable." [45] Readjustment under Section 11 is

tion which would not have been warranted had creditors succeeded in instituting an involuntary proceeding. That decision has no relevance to the question whether the reorganization provisions of the present Act should be construed as intended to mature, without compensating allowances, otherwise unmatured and inchoate liquidation preferences.

[45] Petitioner (Br., p. 15) cites lower federal court precedents and a footnote to *Case* v. *Los Angeles Lumber Products Company*, *supra*, to the effect that the "absolute priority" rule applies in bankruptcy as between classes of stockholders. Petitioner is here using "absolute priority" as synonymous with recognition of liquidation preferences as the sole test of the rights of a senior stock. Treating the bankruptcy reorganization process as a substitute for judicial sale of the assets of a company which is insolvent in either the equity or the bankruptcy sense, makes such an approach appropriate in a bankruptcy reorganization, since a judicial sale or its equivalent under pressure from creditors would be a "liquidation" within the fair intendment of the conventional charter provisions for liquidation preferences. The cases relied on by petitioner are accordingly entirely consistent with the principles applied by the Commission in the administration of Section 11 (e) of the Holding Company Act. These cases are also in accordance with the position which the Commission has followed in the discharge of its advisory functions pursuant to Chapter X of the Bankruptcy Act. It has been noted that the test applied by the Commission to stockholders' readjustments under Section 11 (e) of the Holding Company Act permits no recognition for a junior stock so hopelessly "under water" as to have no reasonable prospect of participation in future income under the existing structure. See note 40, *supra*.

substantially different. Indeed, Power is typical of many companies which require readjustments because of the provisions of Section 11 of the Holding Company Act but which have little or no debt outstanding and no problems with their creditors.[46] Nevertheless, the existence of a top-heavy stock capitalization (which impairs the ability of the company to raise new capital), and of arrears of preferred dividends and deficits in the earned surplus accounts, makes readjustment an urgent necessity apart from the requirements of the Act. However, were it not for the impact of the Act, Power's preferred stockholders could obtain such a reorganization only by coming to terms with the common stockholders and making whatever concessions this might entail.

As we have seen, Congress, in providing machinery to compel reorganization under such circumstances, did not intend to change the substantive nature of the preferred stockholders' contract by maturing their otherwise inchoate liquidation preference. Once this is recognized it is clear that the standard of fairness applied by

[46] Where a registered holding company, unable to meet maturing indebtedness, has been reorganized under Section 11 (e) in lieu of resorting to Chapter X of the Bankruptcy Act, the Commission has, of course, applied the "fair and equitable" standard precisely as if the plan were to be accomplished under Chapter X. *In re Jacksonville Gas Company*, Holding Company Act Release No. 3570 (1942), plan enforced *In re Jacksonville Gas Company*, 46 F. Supp. 852 (S. D. Fla. 1942).

the Commission gave Power's preferred stock their "absolute priority." As the court below observed (R. 134), what the Commission did was strictly in accordance with the test prescribed in *Group of Institutional Investors* v. *C., M., St. P. & P. R. Co.*, 318 U. S. 523, 565, where this Court stated:

> It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered.

II

THE CIRCUMSTANCE THAT THE STATUTORY READJUSTMENT IN THIS CASE TOOK THE FORM OF A LIQUIDATION OF POWER IS NOT DETERMINATIVE OF THE RIGHTS OF THE PREFERRED AND COMMON

Once having concluded that it is the purpose of the Act to preserve, through "fair and equitable" plans, equities of the type represented by Power's common stock, the majority of the Commission held that it could not treat the order prescribing a particular *form* of reorganization as reducing or eliminating the substantive rights of Power's common stockholders vis-a-vis the preferred by maturing the latter's otherwise inchoate liquidation preference. Instead, the liquidation of Power as a separate corporate entity was treated as a mere procedural mechanism for accomplishing reorganization and not as necessitat-

ing a different substantive result from that which would be "fair and equitable" in a recapitalization or merger.

The choice of this particular procedure had been dictated upon purely practical grounds. The *substance* of what the Commission had concluded to be necessary for the simplification of the system was elimination of the stratified character of the stock interest in Power and reduction of the number of corporate entities between the security holders of Power and the basic income-producing properties.

The Commission's opinion in connection with its order of March 20, 1941, clearly indicates the pragmatic nature of the determination that Power should be liquidated as the initial step in the simplification of its holding company system (R. 107–108). Even the selection of Power rather than one of the subsidiary holding companies as the first corporate entity to be eliminated was a matter of practical choice rather than absolute statutory necessity. Even if there had been no possible alternative other than to begin with the elimination of Power as a corporate entity, this could have been accomplished in a number of possible, although less practical, alternative ways—such as the merger or consolidation of Power and Railways, or a one-stock reorganization of Power, followed by dissolution.

The method chosen was deemed to be most economical and expeditious, in the interest of pre-

ferred and common stockholders alike,[47] and, as well, most appropriate in view of the mandate of Section 11 (b) that the Commission proceed "as soon as practicable." The usual considerations for allowing latitude for administrative flexibility in the choice of procedures are particularly applicable here in view of the express injunction of Section 1 (c) that all of the provisions of the Act shall be construed "to meet the problems and eliminate the evils" connected with holding company systems. *Cf. Federal Communications Commission* v. *Pottsville Broadcasting Co.*, 309 U. S. 134, 143. Under these circumstances, to permit the formal device chosen for accomplishing the reorganization to determine the substantive results would be bad public policy and bad law. The only effect would be to indicate that one particular formal device must be avoided by the parties in a corporate readjustment under the Act.

From a legal point of view, we submit that if employment of the device of liquidation matures liquidation preferences which are otherwise in-

[47] It is the consensus of financial comment that liquidation of holding companies will result in increasing the market value of the aggregate security interests affected. See, e. g., *Barrons*, Vol. XXIII, No. 40, p. 15; *The Outlook* (publication of Standard and Poor's Corporation), Vol. 15, No. 13, sec. 1, p. 822, March 29, 1943; *Moody's Stock Survey*, Vol. 33, No. 13, p. 746. In that respect there is no parallel such as petitioner would draw (Br., p. 16) between the termination of useless corporate entities in compliance with Section 11 (b) and a Prohibition Act which puts an end to the operation of a profitable business.

choate, a court would have to hold unfair and inequitable any plan employing the device of liquidation and thereby shifting substantive rights from one group of security holders to another. If we are right under Point I in urging that the common stockholders have valuable existing rights in Power, and if we are right that these rights would be protected in a recapitalization, merger, or consolidation, it would be unfair and inequitable to approve a plan the formal aspects of which would deprive the common stockholders of these substantive rights."[48]

Petitioner apparently does not challenge the proposition that the fortuitous choice of a particular procedure for accomplishing the simplification of a holding company system should not determine the substantive application of the "fair and equitable" standard. In fact petitioner appears to be in complete agreement with our position in stating (Br., p. 26): "It makes no difference in the application of that [fair and equitable] standard what device be used, whether liquidation and dissolution, recapitalization, or merger." Petitioner's argument is merely that Power is no longer (at p. 22) "a free agent in the

[48] Thus, any decision of this Court upholding the Commission's position on Point I, but rejecting the contention that it could achieve the same results in a liquidation, would be in effect a mandate to accomplish a similar division of Power's interest in Railways by following a more devious procedure—a result which could be of no practical benefit to preferred stockholders.

sense that it can recapitalize, merge, consolidate, or take other unregulated corporate action without having to comply with the standards of the Act"—a proposition with which we are, of course, in complete agreement. Petitioner then argues that whatever form the readjustment may take the preferred stockholder's liquidation preference must be treated as a matured claim. This is the contention that we have dealt with in the preceding sections of this brief.

Since, as we have shown, the "fair and equitable" standard in its context and legislative history means that Section 11 should be administered so as to avoid the destruction of legitimate investment values, it is clear that in order to effectuate that policy the charter liquidation preference could be disregarded like any other preexisting contractual provision which comes within the reach of Congress under the commerce power. As this Court held in *Philadelphia, Baltimore and Washington Railroad Co.* v. *Schubert*, 224 U. S. 603 (1912), in invalidating a contract which conflicted with the policy subsequently declared in the Federal Employers Liability Act:

> The power of Congress in its regulation of interstate commerce * * * was not fettered by the necessity of maintaining existing arrangements and stipulations which would conflict with the execution of its policy. To subordinate the exercise of the Federal authority to the continuing

> operation of previous contracts, would be to place, to this extent, the regulation of interstate commerce in the hands of private individuals and to withdraw from the control of Congress so much of the field as they might choose by prophetic discernment to bring within the range of their agreements. The Constitution recognizes no such limitation. It is of the essence of the delegated power of regulation that, within its sphere, Congress should be able to establish uniform rules, immediately obligatory, which as to future action should transcend all inconsistent provisions. Prior arrangements were necessarily subject to this paramount authority.

See, also, *Norman* v. *Baltimore & Ohio R. Co.*, 294 U. S. 240, 307–8.

In *Continental Insurance Company* v. *United States, Reading Co., et al.*, 259 U. S. 156, commonly referred to as the *Reading* case, which was much cited in the legislative history of Section 11, this Court held that "the power of the court under the Sherman Anti-Trust Law to disregard the letter and legal effect of the bonds and general mortgage under the circumstances of this case, in order to achieve the purpose of the law, we can not question."

As noted earlier in this brief, the *Reading* case was considered to furnish an example of a reorganization technique affording sufficient flexibility to permit the carrying out of Section 11 without

impairment of existing legitimate investment interests, and specifically without maturing liquidation preferences (p. 39, *supra*). Petitioner, however, relies on this case as authority for treating liquidation preferences as the sole measure of participation as between different classes of stockholders. This argument is predicated upon the fact that the *Reading* plan in addition to modifying bondholders' rights also contemplated a partial distribution of assets between holders of common stock and holders of noncumulative preference stock (which incidentally had no liquidation preference), and that the allocation among stockholders was determined in accordance with charter provisions. However, the case turned entirely upon the interpretation of the relevant charter provisions and no articulation was given to the "fair and equitable" concept as a reorganization standard. In fact, both the charter rights involved and the nature of the plan are so different from those presented in the instant case that we should hesitate to predict just what disposition the Commission would find to be "fair and equitable" if it were confronted by similar charter provisions and a similar type of plan.[49] Thus, we

[49] The Reading Company preferred stock had a noncumulative dividend preference but was entitled to share equally with common stockholders in liquidation. The plan effected a divestment of the coal properties by transferring them to a new corporation and permitting the Reading Company stockholders to purchase at $2.00 a share certificates entitling them, or their assignees, to receive stock in the new coal com-

question whether Congress intended that the anti-trust decisions should furnish a pattern for the substantive results which might govern in the innumerable reorganizations which Congress foresaw might be necessary to comply with Section 11 of the Holding Company Act.

Petitioner in any event does not question the applicability of the *Reading* case as authority for substantial modification of contract rights where the result is "fair and equitable". Again the area of disagreement between ourselves and petitioner appears to be a narrow one. Petitioner has no difficulty with the power of Congress under the

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pany upon proof that they were no longer interested in the railroad part of the business. The rights had been quoted in the market at from $11 to $20 a share. The Court's analysis indicated that there had been no prospect of payment of a dividend in any such amount apart from the compulsion of the decree, and this aspect of the plan was treated as in effect a liquidation dividend. Under the terms of the charter all classes of stockholders shared alike in liquidation. The common stockholders had a right to current dividends only out of net profits "from the business of any particular fiscal year excluding undivided net profits from previous years," after providing for the preferred dividend from the profits of the particular year. Since there had been an accumulation of undivided profits from prior years and since the preferred stockholders' remaining interest in the Railroad was substantially diminished in value as a result of the divestment of the Coal Company, there is nothing to indicate that the subscription rights in dispute were anything more than the reasonable compensation for the rights surrendered. It is not surprising, therefore, that no one suggested any reason why it might be inequitable to follow the contract provisions.

commerce clause to take away not only the inequitable voting rights of the common stockholders but also their right to have the enterprise (here referring to the enterprise of Power as a holding company) "keep going" (Br., p. 19). But surely the same considerations which warrant exercise of the commerce power to make these substantial changes in the rights of Power's common stockholders would also sustain a modification of the contractual relations between the preferred and common stockholders so as to permit recognition in a plan of the existing legitimate investment interests of each. We have seen that only in this way is it possible for Section 11 to operate as Congress intended.

Petitioner, by focusing exclusively upon the liquidation preference rather than the entire bundle of rights affected by the statutory reorganization process, urges that there can be no modification which will substitute for that liquidation preference any other measure of the preferred stockholders' rights of participation. To that extent petitioner overlooks the fact that the very essence of the reorganization process is the remaking of contract rights and the substitution of equitable equivalents therefor. The equity receivership and bankruptcy precedents, upon which petitioner places so much reliance (although, as we have seen, they are not completely

applicable), do in fact illustrate this disregard of the letter of particular contract rights in order to achieve a result which best protects the substance of all the rights affected.

In *Continental Illinois National Bank & Trust Co.* v. *Chicago, R. I. & P. R. Co.*, 294 U. S. 648 (1935), it was held that a court acting under the reorganization sections of the Bankruptcy Act may enjoin exercise of a contractual right to sell pledged securities pending reorganization. In *Northern Pacific Railway Co.* v. *Boyd*, 228 U. S. 482 (1913), and other cases, the courts without statutory direction imposed equitable limitations on the untrammeled exercise of the right of bondholders to foreclose, to bid in the property, and to dispose of it as they saw fit.[59] Similarly the "up-

[59] The decisions of this Court in the *Monon* case, *Louisville Trust Co.* v. *Louisville, New Albany and Chicago Ry.*, 174 U. S. 674 (1899), and the *Boyd* case, were criticised by leaders of the reorganization bar as unduly restricting the contract right of senior bondholders to sell the properties under a practical arrangement by which stockholders might be induced to contribute new money. See Paul D. Cravath, lecture dated March 1 and 8, 1916, before the Association of the Bar of the City of New York, printed in "Some Legal Phases of Corporate Financing Reorganization and Regulation":

"Three years ago the Supreme Court, in a decision foreshadowed by its opinion in the *Monon* case, placed a very serious and unexpected limitation upon the power of mortgage bondholders to deal in reorganizations with property purchased at foreclosure sale. I refer to the decision in *Northern Pacific Railroad Company* v. *Boyd*."

set price" doctrine created by the courts is a limitation on the contract right to foreclose.[51]

The bankruptcy reorganization legislation merely carried this process one step further in making it possible to dispense with the foreclosure sale entirely and to substitute a procedure under which the court's approval of a plan directly modifies in accordance with its provisions the preexisting claims of security holders.

Petitioner does not question the fact that the reorganization process under the Holding Company Act, as well as in bankruptcy, and in connection with equity receiverships, can completely remake the contract rights of senior and junior securities by reducing both to the same rank.[52] From petitioner's concessions (*supra*, pp. 69–70) it follows that if the results reached in this case could have been accomplished through a recapi-

[51] Control over the upset price was used by the equity courts both to prevent sales in furtherance of what appeared to be an unfair plan and to coerce dissenters' acquiescence in plans that did appear fair. See Weiner, *Conflicting Functions of the Upset Price in a Corporate Reorganization* (1927), 27 Col. L. Rev. 132; S. E. C. Report on Protective and Reorganization Committees, Part VIII (1940), pp. 37 ff.

[52] This Court so held in *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510, and similar results are commonplace in the simplification of the complex structures of holding company systems. In addition to the cases cited in footnote 31, *supra*, see *Commonwealth & Southern Corp.* v. *S. E. C.*, 134 F. (2d) 747 (C. C. A. 3, 1943); *Central and South West Utilities Co.* v. *S. E. C.*, 136 F. (2d) 273 (App. D. C. 1943). Both cases affirmed orders of the Commission requiring "one stock" recapitalizations.

talization of Power, then it is immaterial that this plan is to be consummated through a liquidation which falls within the letter of the charter provision defining the preferred stockholders' preference on liquidation.

Once it be established that the reorganization process may go to the very essence of the respective positions of preferred and common stock by reducing both classes to a common level, it would be anomalous to conclude that any one of the contract rights involved becomes controlling merely because literally applicable to the particular procedural device selected for accomplishing the reorganization, and although adherence to the particular provision would require an inequitable result.

Furthermore, the holding of the majority of the Commission refusing to give literal effect to the charter liquidation preference of the preferred will not disappoint any reasonable expectation of the preferred stockholders. The contingency which allegedly has matured liquidation preferences is one which could not have been anticipated by the parties when the preferred stock was issued in 1929 before the passage of the Holding Company Act.[53]

[53] Indeed, it might well be argued that the contract provision could be disposed of merely by a construction concluding that it is not applicable. A charter provision does not control, even though literally applicable, when the parties did not contract with reference to the contingency that has

Finally, in no realistic sense is there occurring in this case a dissolution of a business enterprise which should call for the application of a charter liquidation preference. As the opinion of the majority of the Commission discloses, the preferred and common stockholders of Power have been the residual co-owners of a vast public utility system controlled through Power, the top holding company, and Railways, its principal subholding company subsidiary. These stockholders will continue to remain the residual owners of the same public utility system, for the principal result accomplished by the Commission's order

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arisen. In *Chicago, Milwaukee & St. Paul Ry. Co. v. Hoyt*, 149 U. S. 1, 15 (1893), the Supreme Court said:

"But where the event is of such a character that it cannot be reasonably supposed to have been in the contemplation of the contracting parties when the contract was made, they will not be held bound by general words, which, though large enough to include, were not used with reference to the possibility of the particular contingency which afterwards happens."

Obviously, the draftsmen of Power's charter did not have in mind the contingency which is now occurring. The preferred stock was issued in 1929, long before the Act was passed. The reference to involuntary dissolution or liquidation was intended, we believe, to cover dissolutions or liquidations compelled by creditors or by reason of nonpayment of franchise taxes, illegal conduct, or the like; not to cover dissolutions incidental to the enforcement of a subsequently enacted public policy which was not and could not have been foreseen in 1929.

However, the Commission chose not to rest its decision on construction of the charter provisions and decided the case on the grounds stated in the text.

is to crack off one of the corporate shells through which their residual ownership was held and to transfer their interests to the stock of the next corporate entity, Railways. In essence, therefore, while Power is being dissolved the enterprise is not.

CONCLUSION

For the reasons stated, the judgment below should be affirmed.

Respectfully submitted.

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APPENDIX A

PERTINENT PROVISIONS OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

SECTION 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things, (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; (2) their service, sales, construction, and other contracts and arrangements are often made and performed by means of the mails and instrumentalities of interstate commerce; (3) their subsidiary public-utility companies often sell and transport gas and electric energy by the use of means and instrumentalities of interstate commerce; (4) their practices in respect of and control over subsidiary companies often materially affect the interstate commerce in which those companies engage; (5) their activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies.

(b) Upon the basis of facts disclosed by the reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first session), the reports of the Committee on

Interstate and Foreign Commerce, House of Representatives, made pursuant to H. Res. 59 (Seventy-second Congress, first session) and H. J. Res. 572 (Seventy-second Congress, second session) and otherwise disclosed and ascertained, it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

(2) when subsidiary public-utility companies are subjected to excessive charges

for services, construction work, equipment, and materials, or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulation which cannot be dealt with effectively by the States;

(3) when control of subsidiary public-utility companies affects the accounting practices and rate, dividend, and other policies of such companies so as to complicate and obstruct State regulation of such companies, or when control of such companies is exerted through disproportionately small investment;

(4) when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties; or

(5) when in any other respect there is lack of economy of management and operation of public-utility companies or lack of efficiency and adequacy of service rendered by such companies, or lack of effective public regulation, or lack of economies in the raising of capital.

(c) When abuses of the character above enumerated become persistent and wide-spread the holding company becomes an agency which,

unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

SEC. 7. (c) The Commission shall not permit a declaration regarding the issue or sale of a security to become effective unless it finds that—

(1) such security is (A) a common stock having a par value and being without preference as to dividends or distribution over, and having at least equal voting rights with, any outstanding security of the declarant; (B) a bond (i) secured by a first lien on physical property of the declarant, or (ii) secured by an obligation of a subsidiary company of the declarant secured by a first lien on physical property of such subsidiary company, or (iii) secured by any other assets of the type and character which the Commission by rules and regulations or order may prescribe as appro-

priate in the public interest or for the protection of investors; (C) a guaranty of, or assumption of liability on, a security of another company; or (D) a receiver's or trustee's certificate duly authorized by the appropriate court or courts; or

(2) such security is to be issued or sold solely (A) for the purpose of refunding, extending, exchanging, or discharging an outstanding security of the declarant and/or a predecessor company thereof or for the purpose of effecting a merger, consolidation, or other reorganization; (B) for the purpose of financing the business of the declarant as a public-utility company; (C) for the purpose of financing the business of the declarant, when the declarant is neither a holding company nor a public-utility company; and or (D) for necessary and urgent corporate purposes of the declarant where the requirements of the provisions of paragraph (1) would impose an unreasonable financial burden upon the declarant and are not necessary or appropriate in the public interest or for the protection of investors or consumers; or

(3) such security is one the issuance of which was authorized by the company prior to January 1, 1935, and which the Commission by rules and regulations or order authorizes as necessary or appropriate in the public interest or for the protection of investors or consumers.

(d) If the requirements of subsections (c) and (g) are satisfied, the Commission shall permit a

declaration regarding the issue or sale of a security to become effective unless the Commission finds that—

(1) the security is not reasonably adapted to the security structure of the declarant and other companies in the same holding-company system;

(2) the security is not reasonably adapted to the earning power of the declarant;

(3) financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest;

(4) the fees, commissions, or other remuneration, to whomsoever paid, directly or indirectly, in connection with the issue, sale, or distribution of the security are not reasonable;

(5) in the case of a security that is a guaranty of, or assumption of liability on, a security of another company, the circumstances are such as to constitute the making of such guaranty or the assumption of such liability an improper risk for the declarant; or

(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

SEC. 11. (a) It shall be the duty of the Commission to examine the corporate structure of every registered holding company and subsidiary com-

pany thereof, the relationships among the companies in the holding-company system of every such company and the character of the interests thereof and the properties owned or controlled thereby to determine the extent to which the corporate structure of such holding-company system and the companies therein may be simplified, unnecessary complexities therein eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and business thereof confined to those necessary or appropriate to the operations of an integrated public-utility system.

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however*, That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system

without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly

or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

(c) Any order under subsection (b) shall be complied with within one year from the date of such order; but the Commission shall, upon a

showing (made before or after the entry of such order) that the applicant has been or will be unable in the exercise of due diligence to comply with such order within such time, extend such time for an additional period not exceeding one year if it finds such extension necessary or appropriate in the public interest or for the protection of investors or consumers.

(d) The Commission may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce compliance with any order issued under subsection (b). In any such proceeding, the court as a court of equity may, to such extent as it deems necessary for purposes of enforcement of such order, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction, in any such proceeding, to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer under the direction of the court the assets so possessed. In any proceeding for the enforcement of an order of the Commission issued under subsection (b), the trustee with the approval of the court shall have power to dispose of any or all of such assets and, subject to such terms and conditions as the court may prescribe, may make such disposition in accordance with a fair and equitable reorganization plan which shall have been approved by the Commission after opportunity for hearing. Such reorganization plan may be proposed in the first instance by the Commission, or, subject to such rules and regulations as the Commission may deem necessary or appropriate in the public

interest or for the protection of investors, by any person having a bona fide interest (as defined by the rules and regulations of the Commission) in the reorganization.

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies

and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

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APPENDIX B

REPORT OF NATIONAL POWER POLICY COMMITTEE ON PUBLIC-UTILITY HOLDING COMPANIES

This report does not attempt to give a comprehensive factual analysis of the position of the holding company in the structure of the electric and gas industries. Those facts have been compiled by the Federal Trade Commission in the course of its thorough investigation of public utility holding companies, and the results of that study have already been reported to the Senate. We are informed that a special report has been prepared for the House Committee on Interstate and Foreign Commerce by Dr. Walter M. W. Splawn, now a member of the Interstate Commerce Commission.

Numerous studies have already shown, and the report of the Federal Trade Commission further demonstrates, that the concentration of control in the electric and gas industries through the device of the holding company has assumed tremendous proportions. While the distribution of gas or electricity in any given community is tolerated as a "natural monopoly" to avoid local duplication of plants, there is no justification for an extension of that idea of local monopoly to embrace the common control, by a few powerful interests, of utility plants scattered over many States and totally unconnected in operation. Such intensification of economic power beyond

the point of proved economies not only is susceptible of grave abuse but is a form of private socialism inimical to the functioning of democratic institutions and the welfare of a free people. In 1933, after an investigation of stock ownership in railroads, Congress amended the Interstate Commerce Act to curb the further use of the holding company as a device for the control of the great transportation systems (U. S. C., title 49, sec. 5). The Banking Act of 1933 provides a measure of control over holding companies in the banking field (U. S. C., title 12, sec. 61). Congress has not yet taken any action regarding the holding company in the gas and electric utility field.

In 1925 holding companies controlled about 65 percent of the operating electric utility industry. By 1932 thirteen large holding groups controlled three-fourths of the entire privately owned electric utility industry, and more than 40 percent was concentrated in the hands of the three largest groups—United Corporation, Electric Bond & Share Co., and Insull. Even these three systems are not totally independent. United Corporation has a stock interest in Electric Bond & Share Co. Into the latter system have been brought certain Insull properties since the collapse of the Insull empire. In 1929 and 1930 twenty large holding-company systems controlled 98.5 percent of the transmission of electric energy across State lines.

The rise to power of the large holding company in the gas utility industry has been no less startling than in the field of electricity. In 1932 eleven holding-company systems controlled 80.29 percent of the total mileage of natural-gas trunk pipe lines, upon which the gas fields are almost

completely dependent for the marketing of their product.

By the pyramiding of holdings through numerous intermediate holding companies and by the issue, at each level of the structure, of different classes of stock with unequal voting rights, it has frequently been possible for relatively small but powerful groups with a disproportionately small investment of their own to control and to manage solely in their own interest tremendous capital investments of other people's money. And the ownership of the stock of operating companies is but one of many devices by which a few clever men have woven the amazing network of control and influence with which they have enveloped and entangled large sectors of the gas and electric utility industry. Voting trusts, interlocking directors and officers, management contracts, the control of proxies, and other means, all have been facilely used to bring about a concentration of control in fewer and fewer hands.

The growth of the holding-company systems has frequently been primarily dictated by promoters' dreams of far-flung power and bankers' schemes for security profits, and has often been attained with the great waste and disregard of public benefit which might be expected from such motives. Whole strings of companies with no particular relation to, and often essentially unconnected with, units in an existing system have been absorbed from time to time. The prices paid for additional units not only have been based upon inflated values but frequently have been run up out of reason by the rivalry of contending systems. Because this growth has been actuated

primarily by a desire for size and the power inherent in size, the controlling groups have in many instances done no more than pay lip service to the principle of building up a system as an integrated and economic whole, which might bring actual benefits to its component parts from related operations and unified management. Instead, they have too frequently given us massive, overcapitalized organizations of ever-increasing complexity and steadily diminishing coordination and efficiency.

For all this concentration so dangerous to his democracy, the American consumer pays the bill. With a large and often unsound capitalization to support, many holding companies have not been able to be satisfied with reasonable dividends on the securities of their operating companies. They have compelled the consumer to bear the burden of various fees, commissions, and other charges which they levy against their subsidiaries. They take fees, usually a percentage of the gross revenues of the subsidiary, under contracts for the performance of management, engineering, accounting, publicity, legal, tax, and other general and special services. They make profits on the sale of materials to their subsidiaries. They make profits from construction contracts which they negotiate and perform for their subsidiaries; they often control one or more construction companies to which is awarded most of the building work for the entire system. They take fees for handling the issue, sale, and exchange of securities for their subsidiaries.

These profits and fees, when dictated by the holding company sitting on both sides of the

transaction, in nowise represent bargains freely and openly arrived at by subsidiary companies on the basis of the lowest cost in a competitive market. There is no semblance of arm's-length bargaining. Competition for construction and other work of public-utility companies in many instances has been substantially eliminated. Independent private enterprise has been crowded out in favor of a none too benevolent private paternalism.

The promoters of the holding-company patchwork have too frequently burdened the operating industry with security charges far beyond the value of the holding company to the industry. Many holding-company securities were issued to acquire new properties, frequently from corporate insiders, at prices often far in excess of any reasonable estimate of the value of those properties and seemingly without heed of the fact that utility properties are required to serve the public under a limitation, in theory at least, of a reasonable return on "value."

The investigation of the Federal Trade Commission shows, for instance, that in 1929 Associated Gas & Electric Co. acquired 94,005 shares of Barstow Securities Corporation, a utility holding company which controlled General Gas & Electric Corporation which controlled a chain of operating companies. The price paid was $531.04 a share. According to the accountants of the Federal Trade Commission, the stock had a book value of $2.97 per share and had earned $4.16 per share in the preceding year. The acquisition was a victory for Associated Gas over the United Gas Improvement Co. (a member of United Cor-

poration group) which had bid against Associated Gas for the property. To finance its purchase of these Barstow securities, with annual earnings of about $391,000, Associated Gas incurred obligations whose annual interest charges were $2,800,000. The example is an extreme one, but acquisitions of properties were common at two, three, or more times their book value, an entry not likely to be understated in an industry where returns are regulated in relation to property value.

Such transactions obviously have no place in a sound economy. They do not serve orderly investment of the Nation's capital in the utility industry. Instead they inject a temporary and unhealthy stimulation into the securities markets which discourages intelligent permanent investors. Real development springs from stable and predicable markets. But stability in the investment market does not very often make a $2.97 stock worth $531.04, nor does it bring old-era profits to investment bankers and brokers. Fundamentally the holding-company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry. As the Federal Trade Commission states in its report:

> Professional managements apparently often give greater attention to the counsel of bankers than to the interest of widely scattered security holders who are the equitable owners of the company so managed * * * In the heyday of holding-company exploitation just prior to the depression, investment bankers not only fur-

nished financial aid when requested by holding companies, but solicited it and came to depend upon holding companies for business.

It is little wonder that these financial holding-company securities have so frequently turned out to be poor investments, for which many investors were induced to exchange their relatively well-secured obligations and stocks of operating utility companies. Too late the investor discovered the difference between the regulated operating companies and unregulated holding companies, and learned how much of his money had been wasted in feeding the hopes and greed out of which vast utility empires were conjured, and how little used to build up the utility enterprise.

Determination of the actual investment in utility properties is the very foundation of any intelligent public regulation of the rates of privately owned and operated utilities. No realistic determination of that kind can be made while holding companies may acquire properties and securities and engineer their transfer through many corporate conduits at fictitious prices. While Federal legislation does not try to regulate intrastate consumers' rates, it can help create conditions under which State legislation can establish rate structures based upon an objective and administratively workable standard of the "prudent investment" in the properties rather than upon the grossly unfair and unreliable variables of "fair value" and "reproduction cost."

We accept the view expressed in the minority report of the New York Commission on Revision

of the Public Service Commissions Law that the decisions of the Supreme Court do not preclude State legislatures from working out a rate policy for the future, which, as to new properties and additions, will be based on the prudent investment in the properties. That has been the accepted policy in Massachusetts and California and was the policy adopted by Congress in the Federal Water Power Act. In the case of properties already dedicated to the utility industry at the time of the adoption of such a policy, the investor and consumer may have to accept "fair value," which, realistically, is nothing more than negotiated or arbitrated value. But in our judgment Congress and the States, within their respective jurisdictions, are free to determine once and for all the "fair value" of existing properties at a particular time and protect both the investor and consumer by providing a definite and predicable rate base for the future.

Substantial strides in this direction can be made now by Federal legislation which will control the accounts, security transactions, and investments of holding companies in relation to the actual prudent investment in the underlying utility properties. The ultimate effect of such legislation should be to encourage holding companies thus freed from excessive capital burdens to adopt a low-rate policy for their operating companies in their own interest. Lower rates and the greater and more economic use of gas and electricity by agricultural, domestic, and industrial consumers implied by lower rates are a necessity for the continued growth of a great in-

dustry and for the realization of its full possibilities.

Attempts by State commissions to protect the consumer from the burdens which holding-company practices have imposed upon him have been, and practically always must be, largely unsuccessful. The public-utility holding companies have become Nation-wide institutions. Their subsidiary operating companies are located in every State. Electric Bond & Share Co. has operating companies in 36 States and 8 other systems have units in 11 to 29 States. Many holding companies have affiliations, sometimes amounting to control, with banking interest, construction companies, coal mines, newspapers, and other interests. Their securities are widely marketed by use of the mails and the instrumentalities of interstate commerce to investors throughout the country. Holding-company operations are too extensive, State commission powers and funds too limited, to make thorough and effective State action possible. And usually the holding companies have purposely arranged their organization and operations to keep out of reach of State regulation; their lawyers have challenged the jurisdiction of such regulation. Generally a holding company itself is incorporated outside the States in which its operating companies are located and carefully does not do business within those States in a manner which will give State commissions technical power to reach the books and records of the holding company. Even if obtainable, however, such books and records will be comparatively unintelligible and even misleading until uniform accounting methods are made compulsory. There

is the further difficulty of allocating the appropriate proportion of the cost of holding-company activities to its subsidiaries in a particular State, coupled with needless waste in having the process duplicated in State after State. These difficulties of State agencies are so fundamental that not even interstate compacts—assuming they could be evolved—can make State regulation practically effective without supplemental help from a Federal law.

The only practical control over public-utility holding companies will be one which can directly reach the holding company itself and supervise its security structure and its use of capital and make possible over a period of time the elimination of the holding company where it serves no demonstrably useful and necessary purpose. Only in that way can Government protect the investors who supply that capital and the consumers who must bear its cost. The need of Federal control is no less imperative because all holding companies have not been guilty of all the abuses that have been indulged in under the holding form. The abuses have not been spasmodic only, but sufficiently widespread to necessitate legislation to protect the public against an inherently dangerous corporate device, which, unregulated, reflects unjustly on guilty and innocent alike.

We therefore recommend Federal legislation regarding public-utility holding companies. Such legislation should eradicate disclosed abuses, prevent the use of the holding company and affiliated interests to obstruct State regulation of operating companies, and make possible the elimination of the holding company where it serves no demon-

strably useful and necessary purpose, without undue dislocation of investment or the loss of operating economies which flow from economically and geographically integrated public-utility systems.

1. The ultimate purpose of the legislation should be the practical elimination within a reasonable time of the holding company where it serves no demonstrably useful and necessary purpose. But the amount of reorganization, transfers of assets, and distributions in dissolution required for the dismantling of our huge holding-company systems is so great that the task of elimination cannot be accomplished in a year or two without possibly too great sacrifice of apparent values. Furthermore, it seems administratively advisable that every opportunity be offered the owners of holding-company securities to work out their own processes of dismantling. That opportunity should, of course, be vigilantly guarded to protect the average investor from the exploitation threatening him almost as a matter of course under our usual methods and mores of corporate reorganization. In destroying the abuses of the holding companies, the Government must not leave great groups of helpless investors to the certain abuses of extensive hurried corporate reorganizations. The dominant groups who have ruthlessly plucked the investor in promoting some of these huge holding companies must not be allowed to pluck him again as reorganization managers.

On the other hand, if the disappearance of the holding-company excrescence is to be realistically expected at the end of a given period, there must

be a constant pressure on the managers of holding-company enterprises, persistent from the very beginning of that period, to insure a continual process of whittling down complicated capital structures and of disassociating operating properties not related to each other geographically or economically: Only such a continual process can guarantee that at the end of the given period the holding companies will have been dismantled into organizations simple enough in structure to be readily dissolved if they are to dissolve, or sufficiently shrunk and integrated for operating purposes so that they may readily be transformed into operating companies. Without such a dismantling process holding-company liquidation at the end of the period may well cost the same sacrifice of investors' interests as would be required to effect their liquidation a year from today. The devices recommended below are devices to effect that continual pressure to compel that continual dismantling process.

2. To attain the flexibility desirable for the handling of this complicated problem in a realistic and prudent way, Federal control should be vested in an administrative commission. Every holding company should be required to register with this commission if, either directly or through subsidiary companies, it employs the instrumentalities of interstate commerce to distribute securities, to transmit or transport electric energy or gas, to perform contracts, or to carry on any business. Furthermore, every holding company should be required to register if it has outstanding securities which were distributed to the public through the channels of interstate commerce, since

by such distribution it has set into motion forces which are still active and are Nation-wide in their effect upon both consumers and investors. At the time of registration, the companies should be required to file with the commission detailed information concerning their financial condition and operations, their security structure, their control over and relations with subsidiaries, and their affiliations with other interest of whatever kind. The definition of a holding company should be broad enough and flexible enough to reach every company which in fact controls public-utility companies, whether or not that control be dependent upon a specified security ownership. Federal registration provides the legal mechanism for controlling the activities of registered holding companies and their associate interests.

3. The issuance of new securities by holding companies should be adequately supervised by the commission so that in reorganizations and rearrangements of properties an uninformed investing public shall not have foisted upon it securities which are in no sense secure and carry little or no voice in management. Security issues should be limited to purposes necessary in the public interest, which accords with the ultimate purposes of the legislation; and each security issued should bear a proper relation to the capital of the company, its existing securities, the securities of the companies in a geographically and economically related system, and, above all, to the prudent investment in the properties of the issuer and its underlying companies. There should be an end to the pyramiding of holding-company securities.

Except for necessary discretionary power in the commission in the case of refunding issues, new securities should be limited to par value common stock, with appropriate voting rights, and to first-lien bonds, i. e., bonds having a first lien either on physical assets of the issuer or upon first-mortgage bonds of operating subsidiaries. In this as in almost every phase of the holding-company problem the ultimate interests of consumers and investors are identical. In a system burdened with overcapitalized and debt-ridden holding companies, the consumers of operating subsidiaries have to support the topheavy structure by paying high rates and by enduring poor service from inadequately maintained plants.

4. The commission should have complete control over the acquisition of new securities and properties by holding companies and others in holding-company systems in the course of reorganizations and rearrangements of properties. New acquisitions should not be allowed unless the applicant can clearly demonstrate a resultant economy and efficiency from the connection of naturally related and interdependent properties. The commission should have power to prevent acquisitions at prices which do not bear a proper relation to the capital prudently invested in the underlying utility properties, or if the acquisition would tend to create monopoly or restraint of trade in the exercise of control of public-utility companies.

5. Holding companies should be restricted as soon as practicable to the business of operating and of owning the securities of public-utility properties; they should not be permitted to engage in nonutility or speculative ventures. Elec-

tric utility and interstate gas transmission or production should be divorced from common control. Similarly, domestic and foreign utilities should be separated. Unless approval of a State commission be obtained, the commission should not permit use of the holding-company form to combine a gas and an electric utility serving the same territory where local law prohibits their combination in a single company.

6. Holding companies should immediately be prevented from borrowing from subholding companies or from operating companies in the same holding-company system. The commission should have power to prevent holding companies and their subsidiaries from paying dividends out of capital or unearned surplus, or from paying any dividend on a security or acquiring or retiring their own securities if such action would endanger the financial integrity of the system or impair the working capital of operating companies. The commission should have authority to prevent the sale of utility assets and securities at prices unfair to investors or in situations where separation of the properties would imperil the efficient interconnection of companies within the group.

7. All other loans and transactions within the systems and with affiliated interests, and the fees paid in connection with such transactions, should be carefully scrutinized and publicized. To prevent the continuing of present abuses and the sheltering of new ones in even subtler and more elusive forms of intercompany relationship than that of holding-company control, it will be necessary in handling intercompany transactions, carefully to define affiliations amounting to less than

control. In speaking of these relationships, the Federal Trade Commission has said:

> the inquiry early disclosed the fact that such companies (affiliates) were frequently used as vehicles whereby certain deals dictated by certain holding companies could be given the appearance of straightforward conservative business transactions, and whereby only a few company executives would know their true significance.

8. The holding company should immediately be required to divest itself of any interest in the business of issuing, underwriting, and creating new security issues for itself or controlled companies, and should not be allowed to derive fees or commissions from security transactions. The holding company in the role of banker is in dangerous conflict with the interests of its investors and consumers.

9. All service, sales, and construction contracts not performed by independent companies should be performed by companies or associations organized on a strictly mutual basis to insure the performance of their work at cost. The commission should have continuous supervision over these mutual organizations to require adequate reports, uniform accounts, the maintenance of equitable allocations of costs among the companies served and the assurance of efficient and economical operation. The commission should make a study and recommendations to State commissions and public utilities concerning the nature, costs, and economies of various kinds of services rendered to different types and sizes of utilities. The provisions

on service, sales, and construction contracts and those regarding other intercompany transactions should put an end to profits from intercompany transactions in a holding-company system. The returns of holding companies would be limited thereby to dividends from their holdings in economically and geographically integrated utility properties.

10. Holding companies should be required to make periodic and other reports concerning their own and their subsidiaries' financial condition and operations. Such reports should be based upon uniform methods of accounting prescribed by the commission, with due regard for the power of the States to prescribe the accounts of operating companies. The requirements concerning reports and accounts should extend to affiliates regarding their transactions with affiliated operating and holding companies. With uniform accounts available to the commission, to State commissions, and to the public, misleading and unsound accounting practices should lessen appreciably, and it should be possible to make intelligent comparisons of performances and to ascertain the investment behind holding-company securities.

11. The commission should study existing systems so that they may be simplified by the elimination of unnecessary corporate complexities and of properties which do not fit into an economically and geographically integrated whole. Simplification and reorganization of holding-company structures, making possible within a reasonable period the practical elimination of the holding company,

should be conducted under the Commission's supervision over a period of time to prevent undue losses to security holders from investment dislocations. Voluntary action by the companies should be encouraged as much as possible, but the commission should be empowered to issue orders compelling necessary divestments, dissolutions, and reorganizations. Such orders should be enforceable in the courts and the commission should act as trustee to effectuate necessary divestments, reorganizations, or dissolutions. The commission should have power to institute proceedings for the reorganization of holding companies under section 77B of the Bankruptcy Act, as amended, and to act as trustee in any proceeding concerning such companies under said section 77B, or receiver in any Federal equity receivership of such companies. No reorganization plan under the Bankruptcy Act, or otherwise, should be effective unless it has been prepared or approved by the commission. Solicitation of proxies, consents, or deposits in connection with a reorganization plan should be prohibited until after a hearing on the plan before the commission. Such solicitation should also be barred unless accompanied by such information regarding the plan, the commission's report thereon, and the interests of the persons sponsoring the plan as will inform the investor adequately of his rights and effect of the plan on his position.

12. The exemption, under the revenue act, for dividends received by corporate holding companies and affiliates on the securities of public-utility companies and other holding companies might

be partially removed. The increased tax occasioned by such a partial removal of this exemption might stimulate active cooperation by holding companies in eliminating intermediate corporate layers and will discourage the use of the holding company as a device for the control of electric and gas utilities except where its use will result in clearly demonstrable economies sufficient to compensate for the tax.

Respectfully submitted.

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